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Abbreviations and symbols used

Member States

BE	Belgium
CZ	Czech Republic
DK	Denmark
DE	Germany
EE	Estonia
EL	Greece
ES	Spain
FR	France
IE	Ireland
IT	Italy
CY	Cyprus
LV	Latvia
LT	Lithuania
LU	Luxembourg
HU	Hungary
MT	Malta
NL	The Netherlands
AT	Austria
PL	Poland
PT	Portugal
SI	Slovenia
SK	Slovakia
FI	Finland
SE	Sweden
UK	United Kingdom

EUR-12	European Union Member States having adopted the single currency (BE, DE, EL, ES, FR, IE, IT, LU, NL, AT, PT, FI)
EU-25	European Union, 25 Member States
EU-15	European Union, 15 Member States before 1 May 2004 (EUR-12 plus DK, SE and UK)

Currencies

EUR	euro
ECU	European currency unit
CYP	Cyprus pound
CZK	Czech koruna
DEM	German mark
DKK	Danish krone
EEK	Estonian kroon
GBP	pound sterling
HUF	forint
JPY	Japanese yen
LTL	litas
LVL	lats
MTL	Maltese lira
PLN	zloty
SIT	tolar
SDR	special drawing right
SEK	Swedish krona
SKK	Slovak koruna
USD	US dollar

Other abbreviations

CPI	consumer price index
ECB	European Central Bank
EMU	economic and monetary union
ERM	exchange rate mechanism
Eurostat	Statistical Office of the European Communities
FDI	foreign direct investment
GDP	gross domestic product
GFCF	gross fixed capital formation
HICP	harmonised index of consumer prices
IMF	International Monetary Fund
IPO	initial public offering

1. INTRODUCTION AND OVERVIEW

1.1. Introduction

A smooth functioning of economic and monetary union (EMU) requires a high degree of convergence among the participating countries. In a single-currency area, convergence will ensure that the single interest rate set at the level of the EMU is appropriate for all its participants. Furthermore, when the economic and monetary union is hit by a shock, a high degree of convergence limits the emergence of asymmetric economic developments at the country level, to which not any longer can be responded by using the exchange rate. Recognising the importance of convergence, the Treaty specifies the criteria to be evaluated and requires the Commission and the ECB to make a report. On 1 May 2004, ten new countries joined the European Union (EU). It was an historical step in the further integration of Europe, because of the sheer size of the enlargement and because the new countries from Central and Eastern Europe had to undergo a transition process from centrally-planned to market economies. They went through comprehensive adjustments and moved a long way in converging to the rest of the EU, but important disparities remain as captured by on average lower income per capita levels. This report makes for the first time an assessment of the convergence criteria applied to the new countries[1].

The single currency, the euro, was introduced on 1 January 1999. This was the result of several years of successful adjustment efforts by the Member States to achieve the high degree of sustainable convergence required for the stability and success of the new currency. The decision[2] by the Council (of Heads of State or Government) on 3 May 1998 in Brussels on the eleven Member States ready to participate in the single currency from the beginning had, in accordance with the Treaty (Article 121(4)), been prepared by the Ecofin Council on a recommendation from the Commission and was based on the two convergence reports made by the Commission[3] and the European Monetary Institute (EMI)[4]. These reports, prepared in accordance with Article 121(1) of the Treaty, examined in considerable detail whether the Member States satisfied the convergence criteria and met the legal requirements[5].

Member States which are assessed as not fulfilling the necessary conditions for the adoption of the single currency have a derogation. In 1998, two Member States had a derogation, namely Greece and Sweden. Article 122(2) of the Treaty lays down provisions and procedures for re-examining the situation of Member States with a derogation (see Box 1.1). At least once every two years, or at the request of a Member State with a derogation, both the Commission and the European Central Bank (ECB) are required to prepare a new convergence report on such Member States.

Box 1.1: Article 122(2) of the Treaty

*At least once every two years, or at the request of a Member State with a derogation, the Commission and the ECB shall report to the Council in accordance with the procedure laid down in Article 121(1). After consulting the European Parliament and after discussion in the Council, meeting in the composition of the Heads of State or Government, the Council shall, acting by a qualified majority on a proposal from the Commission, decide which Member States with a derogation fulfil the necessary conditions on the basis of the criteria set out in Article 121(1), and abrogate the derogations of the Member States concern*ed.

1 The current report makes use of economic data and information available up to 6 October 2004.
2 OJ L 139, 11.5.1998, p. 30.
3 Report on progress towards convergence and recommendation with a view to the transition to the third stage of economic and monetary union, COM(1998)1999 final, 25 March 1998.
4 European Monetary Institute, *Convergence Report*, March 1998.
5 Denmark and the United Kingdom were not the subject of a formal assessment because of their opt-out arrangements.

Greece submitted a request on 9 March 2000 for its convergence situation to be re-examined. The Ecofin Council adopted the decision[6] that Greece fulfilled the necessary conditions for adoption of the single currency on 19 June in Santa Maria da Feira. The decision was taken, having regard to the discussion of the Council, meeting in the composition of Heads of State or Government, and had, in accordance with the Treaty (Article 122(2)), been prepared on a proposal from the Commission. The decision was based on the two convergence reports made by the Commission[7] and the ECB[8]. Greece adopted the single currency with effect from 1 January 2001.

Sweden was re-assessed by the Commission and the ECB, both in 2000[9] and 2002[10] as not fulfilling the necessary conditions for the adoption of the single currency and continues to be referred to as a "Member State with a derogation". Two years have elapsed since the last reports were made by the Commission and the ECB (22 May 2002) and so Sweden is due for re-examination.

In accordance with Article 4 of the Treaty of Accession, the ten countries that joined the EU on 1 May 2004 are "Member States with a derogation". Although the maximum period referred to in Article 122(2) of the Treaty has not elapsed, the timing of the re-examination of Sweden is seized as an opportunity to analyse also the Czech Republic, Estonia, Cyprus, Latvia, Lithuania, Hungary, Malta, Poland, Slovenia and Slovakia. Two other Member States do not participate in the euro. Denmark and the United Kingdom negotiated opt-out arrangements before the adoption of the Maastricht Treaty (Protocols attached to the Treaty). Until these Member States indicate that they wish to join the single currency, they are not the subject of an assessment by the Council as to whether they fulfil the necessary conditions. Such a wish was not expressed by Denmark and the United Kingdom and the present report by the Commission does not deal with them.

6 OJ L 167, 7.7.2000, p. 19.

7 European Commission, *Convergence Report 2000*, COM(2000) 277 final, 3 May 2000.

8 European Central Bank, *Convergence Report 2000*, May 2000.

9 See footnotes 7 and 8 respectively.

10 European Commission, *Convergence Report 2002*, COM(2002) 243 final, 22 May 2002 and European Central Bank, *Convergence Report 2002*, May 2002 respectively.

1.2. Application of the criteria

In accordance with Article 121(1) of the Treaty, the convergence reports shall have to include an examination of the compatibility of national legislation with the Treaty as well as with the Statute of the European System of Central Banks (ESCB) and of the European Central Bank. The reports shall have to further examine the achievement of a high degree of sustainable convergence by reference to the fulfilment of the four convergence criteria dealing with price stability, the government budgetary position, exchange rate stability and the long-term interest rate. Finally, the reports shall have to take into account some additional factors.

1.2.1. Legal compatibility

Chapter 2 of this Working Paper assesses the compatibility between a Member State's legislation, including the statutes of its national central bank, and Articles 108 and 109 of the Treaty and the Statute of the ESCB/ECB. This legal examination mainly covers three areas. First, the objectives of the national central banks (NCBs) must be examined, in order to verify their compatibility with the objectives of the ESCB as formulated in Article 105(1) and Article 2 of the Statute of the ESCB/ECB. The ESCB's primary objective is to maintain price stability. Without prejudice to this objective, it shall support the general economic policies in the Community. Second, the independence of the national central banks and of the members of their decision-making bodies (cf. Article 108) must be assessed. This assessment notably covers all issues linked to an NCB's institutional and financial independence and to the personal independence of the members of its decision-making bodies. Third, the integration of the NCBs into the ESCB has to be examined, in order to ensure that the NCBs act in accordance with the ECB's guidelines and instructions once the country concerned has adopted the single currency.

It appears that none of the eleven Member States being examined is fully compliant in all areas that form part of legal compatibility.

1.2.2. Price stability

The assessment of price stability and inflation convergence (see Chapter 3) is based on the harmonised index of consumer prices (HICP). The average rate of inflation in each Member State has been calculated as the percentage change in the arithmetic average HICP of the latest 12 month relative to the average index of the preceding period. Based on the available information (August 2004), the reference value has been calculated for the purpose of this report as the simple arithmetic average of the average inflation rates in the following three best-performing Member States plus 1.5 percentage point: Finland, Denmark and Sweden. Although the average inflation rate at the moment of the examination was lower in Lithuania (-0.2 percent), this country has been excluded from the calculation of the reference value because countries with negative inflation rates are not considered to be best performers in terms of price stability. Calculated in this way the reference value was 2.4 percent. Of the eleven Member States assessed in this report, five are below this reference value, namely the Czech Republic, Estonia, Cyprus, Lithuania and Sweden. For comparison, the euro area 12 month average over the same period was 2.1 percent.

The factors underlying the inflation developments in the eleven countries under review vary considerably. From inflation rates ranging in the hundreds in some of the former transition economies of Central and Eastern Europe, all countries achieved in recent years single-digit inflation levels. A clear policy orientation towards nominal stability has been key. In Cyprus and Malta, where price movements were much less dramatic, inflation was in particular influenced by international price developments and wages. In Sweden, the stability-oriented macroeconomic policy, including an inflation targeting regime, contributed to maintaining low inflation.

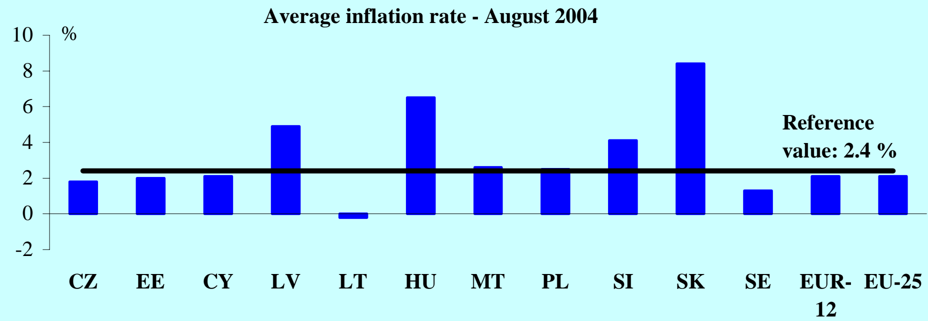
Table 1.1
Current performance of the Member States in relation to convergence

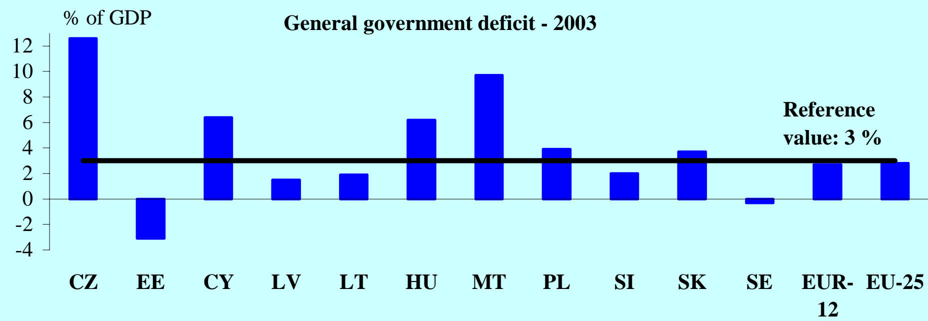
	Legal compatibility	Inflation	Government budgetary position						Exchange rates	Long-term interest rates[3]
		HICP[1]	Existence of an excessive deficit	Deficit[2] (% of GDP)	Debt (% of GDP)	Change from previous year			ERM II participation	
	September 2004	August 2004		2003	2003	2003	2002	2001	September 2004	August 2004
Reference value		**2.4[4]**		**3**	**60**					**6.4[5]**
Czech Republic	no	1.8	yes[6]	12.6	37.8	9.0	3.5	7.1	no	4.7
Estonia	no	2.0	no	-3.1	5.3	0.0	0.9	-0.3	yes[7]	4.6[8]
Cyprus	no	2.1	yes[6]	6.4	70.9	3.5	3.1	2.7	no	5.2
Latvia	no	4.9	no	1.5	14.4	0.3	-0.8	2.0	no	5.0
Lithuania	no	-0.2	no	1.9	21.4	-1.0	-0.5	-0.9	yes[7]	4.7
Hungary	no	6.5	yes[6]	6.2	59.1	1.9	3.7	-1.9	no	8.1
Malta	no	2.6	yes[6]	9.7	71.1	8.4	0.5	5.8	no	4.7
Poland	no	2.5	yes[6]	3.9	45.4	4.3	4.4	-0.1	no	6.9
Slovenia	no	4.1	no	2.0	29.4	-0.1	1.4	0.7	yes[7]	5.2
Slovakia	no	8.4	yes[6]	3.7	42.6	-0.7	-5.4	-1.2	no	5.1
Sweden	no	1.3	no	-0.3	52.0	-0.6	-1.8	1.6	no	4.7
EUR-12		2.1		2.7	70.7	1.3	-0.1	-0.9		4.3
EU-25		2.1		2.8	63.3	1.7	-0.5	-0.8		4.6

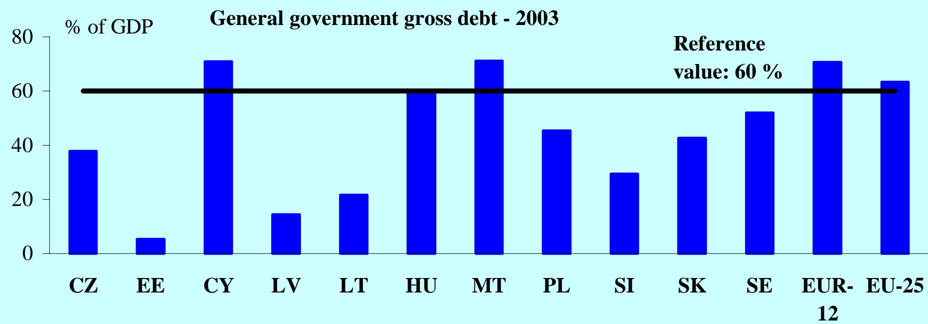
[1] Percentage change in arithmetic average of the latest 12 monthly harmonised indices of consumer prices (HICP) relative to arithmetic average of the 12 monthly HICP of the previous 12 months.
[2] A negative sign indicates a surplus
[3] 10-year benchmark bonds on government debt; average of the last 12 months.
[4] Definition adopted in this report: simple arithmetic average of the inflation rates of the three Member States with the lowest positive inflation rate plus 1.5 percentage points. Lithuania with falling prices has been excluded from the calculation of the reference value.
[5] Definition adopted in this report: simple arithmetic average of the 12-month average of the interest rates of the three Member States used for the calculation of the inflation reference value plus 2 percentage points.
[6] Council decision of 5 July 2004.
[7] Since 28 June 2004.
[8] Bank lending rates; not directly comparable with long-term interest rate data for the other Member States.

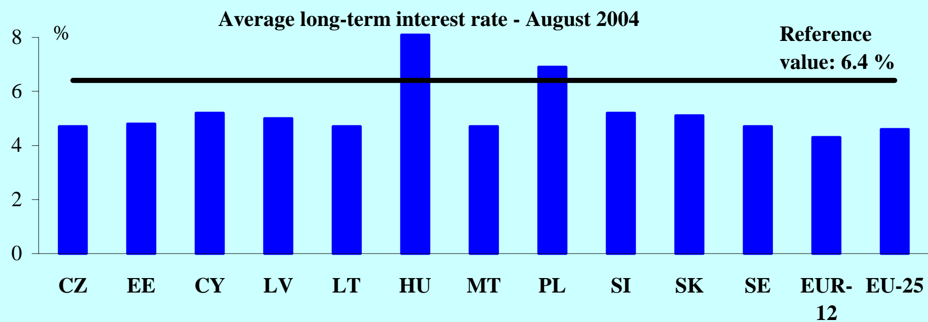
Source : Commission services

Graph 1.1
Key convergence indicators









Source : Commission services

1.2.3. Government budgetary position

The assessment of the criterion on the government budgetary position, discussed in Chapter 4, is linked to the decisions made in accordance with the excessive deficit procedure in Article 104 of the Treaty. Specifically, a Member State is considered to have attained sustainable convergence if it has achieved a budgetary position without an excessive deficit. In turn, the existence of an excessive deficit is determined in relation to the two criteria for budgetary discipline set in Article 104, namely on the government deficit and the government debt.

The situation of the eleven Member States covered by the report is as follows. In 2003, the Czech Republic, Cyprus, Hungary, Malta, Poland and Slovakia all recorded a general government deficit in excess of the 3 percent of GDP Treaty reference value; the remaining five Member States had either a lower deficit or a surplus. Cyprus and Malta also did not respect the government debt criterion in 2003, as they posted debt ratios above the 60 percent of GDP Treaty reference value.

Based on this prima facie evidence for the existence of an excessive deficit, the Commission initiated the excessive deficit procedure for the Czech Republic, Cyprus, Hungary, Malta, Poland and Slovakia in May 2004. On 5 July 2004, the Council decided[11], on a recommendation from the Commission, that an excessive deficit existed in these six Member States. They therefore do not fulfil the budgetary convergence criterion. The other Member States covered by the report (Estonia, Latvia, Lithuania, Slovenia and Sweden) are not the subject of such a Council decision and therefore fulfil the criterion.

In accordance with the Stability and Growth Pact[12], the Member States in the report have submitted for examination by the Council their convergence programmes[13], containing the government's medium-term budgetary plans. In particular, the programmes of the six Member States found in breach of the criteria for budgetary discipline outline the strategies for the correction of this situation, including annual targets for deficit and debt. At the same time as deciding on the existence of an excessive deficit, the Council adopted, on a recommendation from the Commission, recommendations to each of the six Member States on how to correct this situation[14]. In line with the strategies contained in the respective programmes, Cyprus is recommended to bring its deficit below 3 percent of GDP already in 2005 and Malta in 2006, whereas Poland and Slovakia should correct their excessive deficits by 2007 and the Czech Republic and Hungary by 2008.

In most Member States no clear trends emerge for government balances in recent years. While only two Member States, namely Estonia and Sweden, have generally maintained a balanced or surplus position, a gradual trend towards fiscal consolidation is visible in the other Member States fulfilling the budgetary convergence criterion (Latvia, Lithuania and Slovenia). In 2004 a reduction of the deficit is expected in the Member States not fulfilling the budgetary criterion except Slovakia and Poland. Increased deficits or reduced surpluses are expected in the other Member States. While the government debt ratio remains below the 60 percent of GDP reference value in all the eleven Member States except Malta and Cyprus, over the last five years it has increased significantly also in the Czech Republic, Poland and Slovakia and remains only slightly below the reference value in Hungary. In 2004 the debt ratio is projected to increase further in all the Member States with significant stocks of debt except Hungary.

1.2.4. Exchange rate stability

The Treaty refers to the exchange rate criterion as the observance of the normal fluctuation margins of the exchange rate mechanism (ERM) of the European Monetary System for at least two years without severe tensions and in particular without devaluing against the currency of any other Member State. As in previous reports, the assessment of this criterion (see Chapter 5)

11 See website on the Stability and Growth Pact maintained by the Directorate-General for Economic and Financial Affairs: http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm.

12 Council Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies (OJ L 209, 2.8.1997, p. 1).

13 The ten new Member States submitted their first convergence programmes in May 2004. Sweden submitted the most recent update of its convergence programme in December 2003.

14 See footnote 11.

takes into account the regime change which occurred with the introduction of the euro at the beginning of 1999[15], verifies the participation in ERM II (the successor of ERM when the euro was introduced) and examines exchange rate behaviour within the mechanism.

On 28 June 2004, the Estonian kroon, Lithuanian litas and Slovenian tolar joined ERM II with a standard fluctuation band of ±15 percent around their central rate. Over the period of reference, Estonia and Lithuania have successfully maintained their currency board within ERM II while the Slovenian tolar, after having continuously depreciated against the euro in the previous years, has remained very stable.

The Cyprus pound, Czech koruna, Hungarian forint, Cyprus pound, Latvian lats, Maltese lira, Polish zloty, Swedish krona, and Slovak koruna and Swedish krona have not yet joined ERM II. These currencies are characterised by different exchange rate regimes. While three out of four pegged currencies, namely the Cyprus pound, the Latvian lats, and the Maltese lira and the Cyprus pound, have displayed in recent years a fairly stable development vis-à-vis their anchor currencies (respectively the SDR, a currency basket and the euro), the peg of the Hungarian forint to the euro has been less stable in a context of increasing inflation and substantial fiscal deficits. Among the floating currencies, the Czech koruna and Swedish krona were relatively stable against the euro in the last two years, while the Slovak koruna strengthened and the Polish zloty initially depreciated but appreciated recently.

The minimum stay of two years in ERM II is not respected by any of the eleven countries examined, and hence none fulfil the exchange rate criterion.

1.2.5. Long-term interest rate convergence

The criterion on the durability of convergence as reflected in long-term interest rates (see Chapter 6), is based on the assessment of interest rates on 10-year government benchmark bonds, using an average rate over the latest 12 months. Due to the absence of harmonised benchmark bonds or comparable securities in Estonia, partially linked to the low level of government debt in that country, an interest rate indicator has been identified.

The reference value has been calculated as the simple arithmetic average of the long-term interest rates of the three best-performing Member States in terms of price stability plus 2 percentage points. In August 2004, the reference value was 6.4 percent, which is respected by eight of the ten Member States for which long-term interest data are available: the Czech Republic, Latvia, Lithuania, Cyprus, Malta, Slovenia, Slovakia and Sweden.

The interest rate indicator in Estonia, based on long-term bank lending rates, was in the year to August 2004 on average 4.6 percent, which is, however, not directly comparable to the reference value of 6.4 percent. Based on the analysis of developments in the interest rate indicator and taking into account, *inter alia*, the low level of government debt, there are no reasons to conclude that Estonia would not fulfil the long-term interest criterion.

Long-term interest rates in Sweden have been relatively stable, while in the new Member States, they generally declined in the last two years reflecting success in macroeconomic stabilisation. In Hungary and Poland, the process of interest rate convergence has been interrupted in the second half of 2003 on concerns about the authorities' resolve to tackle the mounting government deficits.

1.2.6. Additional factors

The Treaty also requires an examination of other factors relevant to economic integration and convergence. These additional factors, which are, however, not necessary conditions for adopting the euro, are discussed in Chapter 7. They include the results of financial and product market integration and the development of the balance of payments. The examination of the development of unit labour costs and other price indices, which is also prescribed by Article 121 of the Treaty, is covered in the chapter on price stability[16].

15 See Annex D of "Convergence report 2000", COM (2000) 277 final, 3 May 2000.

16 Among the factors of which the convergence reports also have to take account is "the development of the ecu". The provision can be considered obsolete following the irrevocable fixing of the parities between the participating national currencies and the ecu and the

The development and structure of the financial systems in the countries under review varies considerably, with Sweden being the most developed followed by Cyprus and Malta, which have well-established off-shore centres. Financial integration between the Member States assessed in this report and the euro area is quite advanced. Reflecting this, the euro is already playing an important role as a financing and investment currency in the new Member States. Functional links with euro area equity markets have been established as part of a process of global integration. Foreign ownership in the banking sector is more higher in the new Member States than in most of the euro area countries. Only in Slovenia, foreign-owned banks account for less than half of total assets and capital, compared to more than 80 percent in the Czech Republic, Estonia, Lithuania and Slovakia. This high degree of foreign ownership should foster a further modernisation of the financial sector in the new Member States and help to sustain their nominal and real convergence towards the euro area, but will require adequate cross-border cooperation in prudential supervision.

Product markets in the new Member States underwent a considerable structural change in the last 15 years, induced by the transition towards a fully-fledged market economy and by the process of integration with the EU. These developments contributed in particular to greater competition on product markets, which should facilitate economic stabilisation in case of asymmetric shocks. Sweden remains well integrated in the EU economy.

Product market integration is measured through trade, foreign direct investment (FDI), merger and acquisition (M&A) activity and the functioning of the Internal Market. The degree of trade openness of the new Member States is high compared to EU-15 countries and the EU-15 is their major trading partner. The relative importance of intra-EU trade declined somewhat in Sweden in line with the overall trend in the EU-15. The Member States under review received considerable FDI inflows, also in the form of intensified M&A activity, which can be associated with a transfer of know-how. The EU-15 Member States account for around ¾ of the FDI stocks invested in the new Members States. The gradual adoption of the Internal Market *acquis* has contributed to an improved framework for competition in the new Member States, but there is still some way to go.

Recently, current accounts deteriorated in most of the new Member States, but sustainability does not appear in general to be an issue. In particular, in the Baltic States, wide current account deficits are observed in the Baltic States and Hungary. The risk of a balance of payments crisis is reduced as current account deficits have been linked to a strong investment activity underlying the catching-up process and improving the export potential. Furthermore, FDI inflows, which are more stable than short-term capital flows, have to an important extent financed the current account deficits in the new Member States.

converting of the ecu at one-to-one with the euro on 1 January 1999.

2. COMPATIBILITY OF NATIONAL LEGISLATION WITH THE TREATY AS WELL AS WITH THE STATUTE OF THE EUROPEAN SYSTEM OF CENTRAL BANKS AND OF THE EUROPEAN CENTRAL BANK

2.1. Introduction

According to the second sentence of Article 121(1) of the Treaty, the convergence report "*shall include an examination of the compatibility between each Member State's national legislation, including the statutes of its national central bank, and Articles 108 and 109 of this Treaty and the Statute of the ESCB/ECB*"[17].

The present chapter is devoted to this examination. Section 2.2 describes the scope of the adaptations that are necessary to bring national legislation in line with the Treaty and the Statute of the ESCB/ECB and provides a summary description of the main problems encountered in the legislation of the eleven countries under review. Section 2.3 deals with the timing aspects of the necessary legal adjustments. Section 2.4 provides a country-by-country assessment of the compatibility of national legislation with the Treaty and the Statute, with a particular focus on national legislation regarding the central bank.

A summary table of the adjustments to be made by each country, covering both the incompatibilities and imperfections, concludes the chapter.

2.2. Scope of necessary adaptation of national legislation

2.2.1. General

As from 1 January 1999, the competence for monetary policy, exchange rate policy and monetary law has been transferred from participating Member States to the Community level. Naturally, provisions referring to national competence in these fields and setting up national rules are numerous in any jurisdiction. Article 109 of the Treaty reads: "*Each Member shall ensure, at the latest at the date of the establishment of the ESCB, that its national legislation, including the statutes of its national central bank is compatible with this Treaty and the Statute of the ESCB*".

17 ESCB = European system of central banks.

The method by which compatibility is achieved is not specified in the Treaty. Possible methods are repealing of incompatible national provisions, incorporation in national law of language reflecting Treaty or ESCB/ECB Statute provisions, reference to such provisions or a combination thereof.

The examination can be divided into three main areas:

- objectives of national central banks (NCBs) (Article 105(1) of the Treaty);
- independence (Article 108 of the Treaty);
- integration of the NCBs into the ESCB.

Other issues linked to the prohibition of monetary financing (Article 101 of the Treaty) and the prohibition of privileged access (Article 102 of the Treaty) will also be raised whenever appropriate.

As far as the new Member States are concerned, part of these Treaty provisions was considered as *acquis communautaire* to be implemented in legislation by the candidate countries prior to accession. This notably covered the implementation of the statutory objectives of the ESCB and central bank independence. While compliance in these areas was already required at the date of accession, the convergence assessment covers the various elements of this *acquis* since national legislations could have been amended in the meantime. After completing this "baseline assessment", the Commission verifies the integration into national legislation of the elements which were not considered as part of the *acquis* to be implemented prior to accession, in particular the full integration of the NCBs into the ESCB as from the date of adoption of the euro.

The report distinguishes two types of legal difficulties: genuine "incompatibilities" and mere "imperfections":

- "incompatibilities" exist when national legislation is not compliant, e.g. is in contradiction with the Treaty and the ESCB/ECB Statute;
- "imperfections" refer to elements in national legislation which are not explicitly in contradiction with the Treaty, but could be

usefully completed, clarified or made more precise.

2.2.2. Objectives

The objectives of an NCB must be compatible with the objectives of the ESCB as formulated in Article 105(1) of the Treaty (and Article 2 of the Statute of the ESCB/ECB): "*The primary objective of the ESCB shall be to maintain price stability. Without prejudice to the objective of price stability, the ESCB shall support the general economic policies in the Community with a view to contributing to the achievement of the objectives of the Community as laid down in Article 2 [of the Treaty]*".

References in national law to the policy of the government or to specific macroeconomic objectives are not incompatible provided that the primacy of the first objective as well as definition of the second objective of Article 105 of the Treaty is respected.

The primacy of price stability is fully recognised by the national central banks of all eleven Member States. As regards the definition of the secondary objective, imperfections subsist in many national legislations being examined (see Table 2.1 at the end of this chapter). In some cases, no reference is made to the ESCB's secondary objective, while in other instances reference is only made to national economic policies as opposed to the general economic policies of the Community.

2.2.3. Independence

Article 108 of the Treaty ensures that the ESCB will operate free from instructions from third parties. It reads as follows: *"When exercising the powers and carrying out the tasks and duties conferred upon them by this Treaty and the Statute of the ESCB/ECB, neither the ECB nor a national central bank, nor any member of their decision-making bodies shall seek or take instructions from Community institutions or bodies, from any government of a Member State or from any other body. The Community Institutions and bodies and the governments of the Member States undertake to respect this principle and not to seek to influence the members of the decision-making bodies of the ECB or of the national central banks in the performance of their tasks"*.

The different features which make up independence may be grouped into three categories: institutional, personal and financial independence.

(i) Institutional independence

This category includes, for instance, the absence of any right of a body external to the NCB, as far as ESCB-related tasks are concerned:

- to give instructions to a NCB;
- to approve, suspend, annul or defer a decision of a NCB;
- to censor decisions of a NCB on legal grounds;
- to participate in decision-making bodies of a NCB with a right to vote;
- to be consulted before a NCB takes a decision.

The legislation of Estonia, Cyprus, Latvia, Lithuania and Malta is fully compliant as regards the institutional independence of their respective national central banks, while some imperfections subsist in the Czech Republic (the right for the Parliament to reject the annual financial report or to request modifications), Hungary (the Ministry of Justice has the right to review legislative acts of the Magyar Nemzeti Bank), Poland (the Act does not explicitly refer to the independence of the National Bank of Poland's decision-making bodies, while it emphasizes the collaboration between the Bank and the state authorities), Slovenia (the nature of the government's involvement with respect to the management of the Bank of Slovenia's foreign exchange assets should be clarified), Slovakia (the right for the Parliament to oblige the National Bank of Slovakia to modify its annual report) and Sweden (prohibition of seeking or taking instructions only on monetary policy issues and division of powers not clearly defined).

(ii) Personal independence

Certain rules are imposed on national legislation by virtue of Article 14(2) of the Statute of the ESCB/ECB:

- the term of office for the governor must be at least five years;

- a governor may be relieved from office if he no longer fulfils the conditions required for the performance of his duties or if he has been guilty of serious misconduct; he moreover benefits of a right of judicial review.

In view of Article 108 of the Treaty, which covers all members of the decision-making bodies, these rules should not only apply to the governor, but also to the other members who are involved in the performance of ESCB-related tasks. Where a member of a decision-making body with ESCB-related tasks exercises functions outside this body, his or her independence may, depending on the nature of such functions, be jeopardised.

The Central Bank laws and/or Constitution of Cyprus, Lithuania, Malta and Sweden are fully compliant in respect of personal independence, while the legislation of the seven other countries being examined contains some imperfections. In particular, the grounds for dismissal of the governors and of the other members of the decision-making bodies should be brought more closely into line with the provisions of Article 14(2) of the ESCB/ECB Statute (Czech Republic, Estonia, Latvia, Hungary, Poland, Slovenia and Slovakia). Further imperfections also subsist in relation to the possible judicial review for the other members of the decision-making bodies (Czech Republic). In Estonia, the deputy governor's rights should be protected more adequately,

(iii) Financial independence

An NCB must be financially accountable. However, a right for an external body to control ex ante the NCB's budget may, depending on the context, create a situation where an NCB is unable to fulfil its ESCB-related tasks independently. Similarly, a right for a third party to amend, approve or reject the NCB's budget and annual accounts or to control the distribution of the NCB's profits (or capital and/or reserves) would be contrary to the principle of the NCB's financial independence. More specifically, in those countries where third parties and/or parliament are in such a position, directly or indirectly, to exercise influence on the determination of an NCB's budget, annual accounts or the distribution of profit, the relevant statutory provisions should contain a safeguard clause ensuring that this does not impede the proper performance of the NCB's ESCB-related tasks.

The relevant national legislation in the Czech Republic, Estonia, Cyprus, Latvia, Lithuania, Hungary, Malta, Slovenia and Slovakia is compatible with the financial independence requirement. An incompatibility in this area can still be found in the Riksbank Act of Sweden (profits of the Riksbank are allocated by the Riksdag). An imperfection subsists in Poland (annual accounts are submitted for approval to the Council of Ministers).

2.2.4. Integration of NCBs in the ESCB and other legislation

According to Article 9(2) of the Statute of the ESCB/ECB, the ECB shall ensure that the tasks conferred upon the ESCB are implemented either by its own activities or through the NCBs. Furthermore, according to Article 14(3) ESCB/ECB, the NCBs are an integral part of the ESCB, and they shall act in accordance with the guidelines and instructions of the ECB as from the date of adoption of the euro. Therefore, provisions in the statutes of NCBs which stand in the way of the NCBs assuming their role need to be adapted under Article 109 of the Treaty.

The ECB is moreover endowed with legislative powers (Article 110 of the Treaty and Article 34 ESCB/ECB) in order to carry out the tasks entrusted to it and can adopt regulations, decisions, recommendations and opinions which have effect in the euro area Member States. Provisions in national law which are in contradiction with the transfer of these powers from the national to the Community level as from the date of introduction of the euro should be adapted accordingly.

The integration requirement thus implies that, as a minimum, all legal provisions concerned should be rendered obsolete as from the date of entry into the euro area. In addition, specific provisions from the Treaty and the ESCB/ECB Statute (or references thereto) could be reflected into national legislation, notably for clarification purposes.

The following sections classify and explain the main problems encountered in relation to integration into the ESCB. As certain types of difficulties exist in the legislation of a large number of Member States, they will be discussed in greater detail in the country-specific assessments in section 2.4 below.

(i) General issues

In order to properly reflect that the different NCBs form an integral part of the ESCB and have to act in accordance with the guidelines and instructions of the ECB as from the date of adoption of the euro, it is appropriate to include an explicit provision to this effect in the different NCB acts (as is for instance the case in the relevant legislation of the Czech Republic, Lithuania and Slovenia).

In some countries (the Czech Republic, Estonia and Slovakia), the legislation does not fully reflect the ECB's legislative powers stemming from Article 110 of the Treaty, including the possibility to impose fines and periodic penalty payments, and these incompatibilities should therefore be removed.

(ii) Definition and implementation of monetary policy

With the exception of Slovenia, all other countries being examined fail to acknowledge the ESCB's competence for the definition and implementation of monetary policy as from the date of introduction of the euro. The relevant provisions should therefore be made compatible with Article 105 of the Treaty and Article 12(1) ESCB/ECB.

(iii) Foreign exchange operations; definition of foreign exchange policy

The national legislation of Hungary, Poland and Slovakia does not recognise the ESCB's role in respect of the conduct of foreign exchange operations (Article 105(2) of the Treaty) and needs to be made compatible in this respect.

With respect to the definition of foreign exchange policy, the legislation in all countries except Slovenia fails to allow for the Council, by virtue of Article 111 of the Treaty, to define the exchange rate policy in relation to the euro and/or to conclude international agreements concerning monetary or foreign exchange matters.

(iv) The holding and managing of foreign reserves

As from the introduction of the euro, a number of statutory provisions come into play, such as the mandatory transfer of a certain volume of foreign reserve assets to the ECB (Article 30 ESCB/ECB) and the need for ECB approval of foreign exchange transactions by participating NCBs and by their Member States (working balances) above a certain limit (Article 31 ESCB/ECB). Incompatibilities in this respect should be removed in several countries (Czech Republic, Estonia, Latvia, Lithuania, Hungary, Malta, Poland and Slovenia).

(v) Euro banknotes and coins

National legislation should not contain any provisions which are in contradiction with the ECB's exclusive right to authorise the issue of euro banknotes (Article 106(1)) as well as the volume of euro coins (Article 106(2)) in the euro area. Similarly, decisions on the denominations and technical specifications of euro coins intended for circulation are not a national competence but are adopted by the Council (Article 106(2)). Incompatibilities exist in the legislation of all eleven countries.

(vi) Instruments of monetary control

Incompatibilities relating to the choice of monetary control instruments being used, and the rules applying to their implementation, can be found in the legislation of all eleven Member States being examined. These relate to the responsibility for decisions relating to open market and credit operations (cf. Article 18(2) ESCB/ECB), the calculation and determination of minimum reserves (cf. Article 19(1) ESCB/ECB) as well as the Council's role laid down in Article 19(2) with respect to the basis, the maximum permissible ratios and the appropriate sanctions of such minimum reserves. Article 20 ESCB/ECB moreover confers a broadly defined competence to the ECB in the definition of monetary control methods, with the Council also becoming involved to the extent that such methods impose obligations on third parties.

(vii) Financial provisions

The inadequate reflection of the role of the ECB Governing Council and of the EU Council in the process of selecting independent external auditors (cf. Article 27(1) ESCB/ECB) constitutes the main source of incompatibilities in this area (Czech Republic, Estonia, Latvia, Hungary, Malta and Slovakia). Further

incompatibilities exist in a few countries (Estonia, Latvia, Poland and Slovakia) as regards the involvement of the respective state audit offices in the audit of the national central banks.

(viii) Other issues linked to integration

The participation of national central banks in international monetary institutions (when acting in their own capacity) is subject to approval by the ECB (cf. Article 6 ECSB/ECB). Central bank legislation in Cyprus and Lithuania is problematic in this respect.

Article 105(4) of the Treaty obliges national authorities to consult the ECB on any draft legislative provision in its field of competence. The national legislation in several countries provides for a similar obligation to consult the NCB on draft legislation. Once the NCB concerned forms part of the Eurosystem, it would be logical to confine such consultations to the ECB, particularly if the draft legislation is related to ESCB-related tasks.

2.2.5. Prohibition of monetary financing

A number of central bank acts refer to the possible granting of emergency loans to credit institutions in certain exceptional circumstances, notably in order to safeguard the stability of the financial system (cf. Article 14 of the Act on the National Bank of Hungary and Article 15(1)(g) of the Central Bank of Malta Act), as part of a bank rehabilitation programme (cf. Articles 42(3)-(4) of the Act on the National Bank of Poland) or in order to maintain bank liquidity (Article 24(2) of the Act on the National Bank of Slovakia). Safeguards should be in place in order to avoid that the national central banks concerned might eventually end up bearing financial costs to be borne by the state, as monetary financing (prohibited by Article 101 of the Treaty) would otherwise be involved.

Similarly, the possibility for certain national central banks to grant loans or to advance credit to deposit guarantee funds and/or other guarantee funds, notably in the event of temporary or long-term deficits, should be clarified. This is for example the case in Hungary (Article 71(3) of the MNB Act provides for possible lending to the Guaranteed Fund of the Funds), Poland (Article 43 of the NBP Act refers to the possible extension of loans to the Bank Guarantee Fund) and Slovakia (Articles 24(3) and 36(1) of the SNB Act relate to the Deposit Protection Fund). If the central banks concerned could thereby end up bearing unrecoverable losses and thereby assuming financial responsibilities to be borne in principle by the state budget, this would constitute a form of monetary financing contrary to Article 101 of the Treaty.

2.2.6. Legislation outside the scope of Article 109 of the Treaty

The elements of national legislation which are addressed above can be compared directly with provisions of the Treaty and the ESCB/ECB Statute. Any necessary adjustments in these areas are to be made by virtue of Article 109 of the Treaty.

A country adopting the single currency will have to make further adjustments in order to comply with detailed rules and obligations laid down by the ECB (e.g. confidentiality regime of national central banks, rules for the introduction and withdrawal of euro banknotes, etc.), or with secondary legislation adopted by the Council (e.g. the legal framework which has been established for the fight against counterfeiting of euro banknotes and coins). Such adaptations fall under the general obligation of Member States to remove incompatibilities with EC law from their national legislation (cf. Article 10 of the Treaty) although, strictly speaking, they do not form part of the "convergence" examination under Article 122(2). While the present report does not address incompatibilities or other problems which may exist in this area, it is very important that Member States bring all such national legislation into line at the date specified in secondary legislation or when the ECB specifies the respective rules.

This report does not examine whether national legislation complies with the Treaty in general, that is with any obligation of Member States to adapt their national legislation to Community law other than those obligations which follow from the transfer of competences in the context of EMU.

2.3. Timing of adaptation

Article 109 requires Member States to "ensure" that their legislation is compatible with the Treaty. Compatibility is only achieved when the legislative

process is completed. This applies to the three areas identified above (legislation related to the definition of an NCB's objectives, independence as well as integration into the ESCB). However, the distinction between the three areas is important when it comes to determining the date from which legislation must become applicable.

The requirements linked to the start of the second stage of EMU became applicable as from 1 January 1994 (cf. Article 116 of the Treaty). Incompatibilities relating to the independence of an NCB (Article 108) needed to be effectively removed by the Member States at the date of establishment of the ECB (Article 109), that is, the relevant changes in legislation needed not only to be adopted, but also needed to be in force at that particular date (1 June 1998). Other areas of legislation, in particular those which relate to the integration of an NCB into the ESCB, need to become effective at the latest when a country adopts the single currency and the responsibility for monetary policy is transferred to the ECB.

The 2004 convergence report constitutes the first convergence assessment for the ten Member States which joined the European Union on 1 May 2004. They joined the EU as Member States with a derogation by virtue of Article 4 of the Accession Treaty. These countries were under the obligation, in all EU policy areas, to ensure the compatibility of their national legislation with the Community *acquis* before their accession. As regards EMU, and the requirements stemming from Article 109 of the Treaty in particular, full compliance with "Stage II" requirements was required, as well as the independence of their national central bank. Similarly, compliance with the objectives of the ESCB was considered important, notably in view of the direct link between central bank independence and the pursuit of the central bank's objectives.

The full integration of the NCBs into the ESCB was considered as part of the post-accession legal requirements, which are associated with Member States' preparations for their future entry into the euro area. Since the present convergence assessment comes in only a few months after accession, and well before the end of the minimum period of two years before any of the ten Member States can adopt the euro, quite a few integration issues are still outstanding and the large majority of incompatibilities is related to this particular area. In view of the wording of Article 109 of the Treaty, the new Member States are expected to adjust their national legislation as soon as possible after their accession to the EU, even though the adjustments need to become effective only when a country adopts the single currency and the responsibility of its central bank for the conduct of monetary policy is transferred to the ECB. Member States are thus expected to initiate action in order to ensure compliance in time for the next Convergence Report.

2.4. Situation in the Member States

The country-by-country examination provides some background information on the NCB concerned (history, internal organisation, relevant legislation) and subsequently examines the degree of compatibility as regards objectives, independence and integration. Problematic legal provisions are explicitly listed, while an indication is provided on whether the provision in question is to be considered as incompatible with the Treaty, or whether it rather constitutes an imperfection [18]. Each country section is concluded by a brief overall assessment on the degree of compatibility.

2.4.1. Czech Republic

2.4.1.1. Current legal situation

Introduction

The Czech National Bank (CNB) was established on 1 January 1993, following the division of the State Bank of Czechoslovakia. Its creation was based on the Czech National Council Act No 6/1993 adopted on 17 December 1992. This Act was last amended in 2002 by Act No 127/2002, which entered into force on 1 May 2002, while amendments adopted in 2000 entered into force on 1 May 2004.The supreme governing body of CNB is the Bank Board composed of seven Members (including the governor of the CNB), who are appointed and dismissed by the president of the Republic.

Objectives

The objectives of the CNB Act are fully compliant with those of the ESCB.

18 Unless indicated otherwise, the references relate to specific articles in the respective national central bank acts.

Independence

No incompatibilities with the Treaty exist in this area. The possibility for the Chamber of Deputies of approving or rejecting the annual financial report and to request modifications (Article 47(3)-(5)) could however impinge upon the central bank's institutional (and possibly also financial) independence. In addition, the grounds for dismissal of the governor and of the other members of the decision-making bodies (Article 6(11)-(13)) should be brought more closely in line with Article 14(2) of the ESCB/ECB Statute and a right of judicial review should exist for the other members of the decision-making bodies.

Integration in the ESCB

The incompatibilities in this area are linked to the following ESCB/ECB tasks:

- the legislative power of the ECB (Articles 5(2)a and 37);
- the definition of monetary policy (Articles 2(2)a, 5(1) and 23);
- the conduct of foreign exchange operations and the definition of foreign exchange policy (Article 35a);
- the holding and managing of foreign reserves (Article 1(4); Article 35d contains an imperfection);
- the right to authorise the issue of banknotes and the volume of coins (Articles 12, 13 and 22; Article 2(2)b contains an imperfection);
- the monetary functions, operations and instruments of the ESCB (Articles 23, 25, 26, 28, 29, 32 and 33);
- the financial provisions related to the ESCB (Article 48(2)).

2.4.1.2. Assessment of compatibility

As regards central bank integration into the ESCB at the time of euro adoption, legislation in the Czech Republic, in particular the Czech National Bank Act, is not fully compatible with Article 109 of the Treaty and the ESCB/ECB Statute.

In addition, the correction of some residual imperfections is recommended. The Czech National Bank Act contains imperfections linked to the CNB's integration into the ESCB and in the field of institutional and personal independence.

2.4.2. Estonia

2.4.2.1. Current legal situation

Introduction

Eesti Pank was originally founded on 24 February 1919 and was restored as Estonia's central bank in the 1990s. A monetary reform was implemented in 1992 based on the establishment of a currency board linked to the DEM, and to the euro as from 1999. The Eesti Pank Act was adopted on 18 May 1993 and last amended on 29 January 2003.

The decision-making bodies of Eesti Pank are the governor of the Central Bank and the Supervisory Board. The president of the Republic appoints the governor on the proposal of the Supervisory Board. The governor is the sole body vested with responsibility for formulating monetary policy.

Objectives

Article 2(1) and/or 4(4) of the Eesti Pank Act should include a reference to the secondary objective of the ESCB, while the objectives of regulating currency circulation, of upholding the stability of the national currency and of supporting the economic policy of the Government should be subordinated to the primary and secondary objectives of the ESCB.

Independence

No incompatibilities with the Treaty exist in this area. The grounds for dismissal of the governor and the chairman and members of the Supervisory Board (Article 12(1)) should however be adapted by bringing them closer into line with Article 14(2) of the ESCB/ECB Statute. Similarly, the position of the deputy governor should be strengthened (Article 10(4)) as the governor could transfer his authority to him under certain circumstances.

Integration in the ESCB

The incompatibilities in this area are linked to the following ESCB/ECB tasks:

- the legislative power of the ECB, including regarding possible sanctions (Articles 2(7), 14(3) and (8)) as well as the absence of a general reference to the Eesti Pank as an integral part of the ESCB and to its subordination to the ECB's legal acts (Article 1(3) contains an imperfection);
- the definition of monetary policy (Articles 14(3) and (6); Article 2(4) contains an imperfection);
- the conduct of foreign exchange operations and the definition of foreign exchange policy (Articles 2(1));
- the holding and managing of foreign reserves (Article 26(4); Article 2(3) contains an imperfection);
- the right to authorise the issue of banknotes and the volume of coins (Articles 2(2) and 9(2)9);
- the monetary functions, operations and instruments of the ESCB (Articles 2(7), 14(4) and 14(7)-(8));
- the financial provisions related to the ESCB (Articles 9(2)7[1] and 31(1) contain an imperfection).

The Constitution of the Republic of Estonia (Article 111) is not compatible with the EC Treaty and the ESCB/ECB Statute, since it attributes to the sole Eesti Pank the right to issue the Estonian currency as well as the tasks of regulating currency circulation and upholding the stability of the Estonian currency. The currency law contains similar incompatibilities as regards the definition of monetary unit (clauses 1 and 3), the right to authorise the issue of money (clause 2), as well as the definition of the foreign exchange policy (clause 5). The law on the security for Estonian Kroon also contains incompatibilities as regards the definition of the foreign exchange policy (clauses 1-3) and regarding the right to issue currency (clause 4).

2.4.2.2. Assessment of compatibility

As regards central bank integration into the ESCB at the time of euro adoption, legislation in Estonia, in particular the Eesti Pank Act, the Constitution of the Republic of Estonia as well as the currency law and the law on the security for Estonian kroon, is not fully compatible with Article 109 of the Treaty and the ESCB/ECB Statute.

In addition, the correction of some residual imperfections is recommended. The Eesti Pank Act contains a number of imperfections related to its integration into the ESCB. Imperfections also subsist as regards the Bank's objectives as well as the personal independence of the members of its decision-making bodies.

2.4.3. Cyprus

2.4.3.1. Current legal situation

Introduction

The Central Bank of Cyprus (CBC) was established by the Central Bank of Cyprus Law in 1963, shortly after the island gained its independence in August 1960. The law was replaced by the Central Bank of Cyprus Law of 2002 (138(I)2002), as amended by the CBC (amendment) Law of 31 October 2003. The CBC is a corporate entity while its capital has been paid up by the government.

The decision-making bodies of the CBC are the Board of Directors, the Monetary Policy Committee, the governor and the deputy governor. The Monetary Policy Committee, composed of the governor, the deputy governor and five other members, defines and implements monetary policy and decide on matters related to the conduct of exchange rate policy and the operation of the payment and settlement systems.

Objectives

The secondary objective of the CBC (Article 5) refers to the general economic policy of the State. It should moreover make reference to the general economic policies in the Community, with the latter taking precedence over the former.

Independence

The CBC Law is compatible with the Treaty in this respect.

Integration in the ESCB

The incompatibilities in this area are linked to the following ESCB/ECB tasks:

- the absence of a general reference to the CBC as an integral part of the ESCB and to its subordination to the ECB's legal acts (Article 3 contains an imperfection);
- the definition of monetary policy (Articles 6(2)a and 10);
- the conduct of foreign exchange operations and the definition of foreign exchange policy (Articles 6(2)b, 10 and 37);
- the holding and managing of foreign reserves (Articles 6(2)c and 33 to 36 contain an imperfection);
- the right to authorise the issue of banknotes and the volume of coins (Articles 29, 30 and 31(2));
- the definition of the monetary unit (Articles 27 and 28);
- the monetary functions, operations and instruments of the ESCB (Articles 39(2), 40(1)a, 40(2), 41(1), 44, 46(2)-(3)) and 65;
- the need for the ECB's prior approval for the participation of an NCB in international monetary organisations (Article 6(2)g contains an imperfection).

2.4.3.2. Assessment of compatibility

As regards central bank integration into the ESCB at the time of euro adoption, legislation in Cyprus, in particular the Central Bank of Cyprus Law, is not fully compatible with Article 109 of the Treaty and the ESCB/ECB Statute.

In addition, the correction of some residual imperfections is recommended. The Central Bank of Cyprus Law contains some imperfections with respect to its integration into the ESCB, while an imperfection subsists in its objectives.

2.4.4. Latvia

2.4.4.1. Current legal situation

Introduction

The Bank of Latvia was founded in 1922 and re-instated in 1991 under the Bank of Latvia Law, as last amended on 20 June 2002.

The decision-making bodies of the Bank of Latvia are the Board of governors, chaired by the governor of the Central Bank, and the Executive Board. The Board of governors is the sole body involved in decision-making as regards ESCB-related tasks.

Objectives

The wording of the Bank of Latvia's primary objective (Article 3) should reflect the wording of Article 105(1) of the Treaty more closely, while a reference to the secondary objective of the ESCB should be introduced.

Independence

No incompatibilities with the Treaty exist in this area. The grounds for dismissal of the governor and the other members of the Board of Governors (Article 22) should however be adapted by bringing them closer into line with Article 14(2) of the ESCB/ECB Statute.

Integration in the ESCB

The incompatibilities in this area are linked to the following ESCB/ECB tasks:

- the absence of a general reference to the Bank of Latvia as an integral part of the ESCB and to its subordination to the ECB's legal acts (Article 2 contains an imperfection);
- the possibility for the Parliament to wind up the Bank of Latvia (Article 17);
- the definition of monetary policy (Article 26);
- the conduct of foreign exchange operations and the definition of foreign exchange policy (Article 4);
- the holding and managing of foreign reserves (Article 8; Article 5 contains an imperfection);
- the right to authorise the issue of banknotes and the volume of coins (Articles 4 and 34);
- the monetary functions, operations and instruments of the ESCB (Article 38);
- the financial provisions related to the ESCB (Article 43).

2.4.4.2. Assessment of compatibility

As regards central bank integration into the ESCB at the time of euro adoption, legislation in Latvia, in particular the Law on the Bank of Latvia, is not fully compatible

with Article 109 of the Treaty and the ESCB/ECB Statute.

In addition, the correction of some residual imperfections is recommended. In particular, imperfections subsist in respect of the objectives and the personal independence of the members of the Bank of Latvia's decision-making bodies.

2.4.5. Lithuania

2.4.5.1. Current legal situation

Introduction

The Bank of Lithuania started operating in 1922 and was re-established in March 1990. As from April 1994, the litas was linked to the US dollar via a currency board. In February 2002, the euro became the anchor currency of Lithuania's currency board. The Law on the Bank of Lithuania, as last amended on 15 April 2004, constitutes the legal basis for the establishment of the Bank of Lithuania.

The decision-making bodies of the Bank of Lithuania are the chairperson and the Board. The Board formulates Lithuania's monetary policy.

Objectives

The secondary objective of the Bank of Lithuania (Article 7(2)) refers to the general economic policy of the State. It should moreover make reference to the general economic policies in the Community, with the latter taking precedence over the former.

Independence

No incompatibilities with the Treaty exist in this area.

Integration in the ESCB

The incompatibilities in this area are linked to the following ESCB/ECB tasks:

- the possibility for the Parliament to wind up the Bank of Lithuania (Article 1(3));
- the definition of monetary policy (Articles 8(1)2 and 11(1)1);
- the conduct of foreign exchange operations and the definition of foreign exchange policy (Articles 8(1)3, 11(1)3 and 31);
- the holding and managing of foreign reserves (Articles 11(1)4 and 11(1)17; Article 33 contains an imperfection);
- the right to authorise the issue of banknotes and the volume of coins (Articles 6, 8(1)1 and 11(1)9);
- the monetary functions, operations and instruments of the ESCB (Articles 11(1)2, 11(1)5, 25-27, 29, 30 and 32);
- the need for the ECB's prior approval for the participation of an NCB in international monetary organisations (Article 11(1)8).

Article 125 of the Constitution of Lithuania attributes to the Bank of Lithuania an exclusive right to issue banknotes and is therefore not fully compatible with the Treaty and the ESCB/ECB Statute. The law on currency contains incompatibilities as regards the definition of the monetary unit (Articles 1 and 3), the right to authorise the issue of banknotes and the volume of coins (Article 2) and the definition of the foreign exchange policy (Article 4). The law on the credibility of the Litas contains similar incompatibilities as regards the right to issue currency (Articles 1-2) and the definition of the foreign exchange policy (Article 3).

2.4.5.2. Assessment of compatibility

As regards central bank integration into the ESCB at the time of euro adoption, legislation in Lithuania, in particular the Law on the Bank of Lithuania, the Constitution of Lithuania as well as the law on currency and the law on the credibility of the litas, is not fully compatible with Article 109 of the Treaty and the ESCB/ECB Statute.

In addition, the correction of some residual imperfections is recommended. In particular, an imperfection subsists as regards the Bank's objectives.

2.4.6. Hungary

2.4.6.1. Current legal situation

Introduction

The Magyar Nemzeti Bank (MNB) originally started its operations in 1924 and restarted to operate as a central bank in 1987. The Act on the MNB, which was adopted in October 1991, re-instated the Bank's independence. The legal basis for the operations of the MNB is now contained in Act LVIII of 2001 as last amended in 2004; further provisions can be found in the MNB's Statutes.

The MNB's decision-making bodies are the General Meeting, the Monetary Council, the Board of Directors and the Supervisory Board. The Monetary Council is the supreme decision-making body as regards the basic tasks of the MNB.

Objectives

The secondary objective of the MNB (Article 3) refers to the general economic policy of the State. It should moreover make reference to the general economic policies in the Community, with the latter taking precedence over the former.

Independence

The possibility for the Ministry of Justice to review certain legislative acts of the MNB (Article 60(3)) could affect the MNB's institutional independence (imperfection). The grounds for dismissal of the members of the Monetary Council (Articles 49(10)a-b) constitute a further imperfection with respect to Article 14(2) of the ESCB/ECB Statute.

Integration in the ESCB

The incompatibilities in the central bank act are linked to the following ESCB/ECB tasks:

- the absence of an explicit reference to the subordination of the MNB to the ECB's legal acts (Article 1 contains an imperfection);
- the definition of monetary policy (Articles 4(1), 6, 7, 12 and 60(1)a);
- the conduct of foreign exchange operations and the definition of foreign exchange policy (Articles 7d and 11(2)-(3));
- the holding and managing of foreign reserves (Article 61(5));
- the right to authorise the issue of banknotes and the volume of coins (Articles 4(2) and 31);
- the monetary functions, operations and instruments of the ESCB (Articles 5-7, 9, 10, 14, 30, 60(1)b-c);
- the financial provisions related to the ESCB (Article 48d).

Chapter 6 Article 32/D of the Constitution Act attributes the competence for monetary policy to the Magyar Nemzeti Bank without reference to the ESCB's role in this respect.

2.4.6.2. Assessment of compatibility

As regards central bank integration into the ESCB at the time of euro adoption, legislation in Hungary, in particular the Magyar Nemzeti Bank Act and the Constitution Act, is not fully compatible with Article 109 of the Treaty and the ESCB/ECB Statute.

In addition, the corrections of some residual imperfections is recommended. In particular, imperfections subsist as regards the Bank's objectives as well as the institutional and personal independence.

2.4.7. Malta

2.4.7.1. Current legal situation

Introduction

Following Malta's independence in 1964, the Central Bank of Malta (CBM) was established in April 1968 on the basis of Central Bank of Malta Act (1967). The CBM became an independent central bank pursuing price stability as its primary objective following amendments to the Act passed in October 2002.

The decision-making bodies of the CBM are the governor and the Board of Directors. A Monetary Policy Advisory Board has also been established. The sole authority and responsibility to take decisions and to perform any function or duty or to exercise any power relating to monetary policy vests in the governor.

Objectives

The secondary objective of the CBM (Article 4(1)), which refers to "orderly and balanced economic development" should reflect the ESCB's secondary

objective more closely. In addition, Article 4(2) should refer to the tasks of the CBM rather than to its objectives.

Independence

The CBM Act is fully compatible with the Treaty in this respect.

Integration in the ESCB

The incompatibilities in this area are linked to the following ESCB/ECB tasks:

- the absence of a general reference to the CBM as an integral part of the ESCB and to its subordination to the ECB's legal acts (Article 3 contains an imperfection);
- the definition of monetary policy (Articles 4(2)a, 17a(1) and (4-5), as well as 17d(1)-(3));
- the conduct of foreign exchange operations and the definition of foreign exchange policy (Article 40; Article 4(2)b contains an imperfection);
- the holding and managing of foreign reserves (Articles 15(2), 15(2)b, 19(1) and 41);
- the right to authorise the issue of banknotes and the volume of coins (Articles 41, 42 and 43(1)-(4));
- the definition of the monetary unit (Article 39);
- the monetary functions, operations and instruments of the ESCB (Articles 15(1)c-g and 37(1)-(3));
- the imposition of sanctions (Article 52a);
- the financial provisions related to the ESCB (Article 22).

2.4.7.2. Assessment of compatibility

As regards central bank integration into the ESCB at the time of euro adoption, legislation in Malta, in particular the Central Bank of Malta Act, is not fully compatible with Article 109 of the Treaty and the ESCB/ECB Statute.

In addition, the correction of some residual imperfections is recommended. The Central Bank of Malta Act suffers from imperfections related to the need for integration into the ESCB and as regards the formulation of the CBM's objectives.

2.4.8. Poland

2.4.8.1. Current legal situation

Introduction

The National Bank of Poland (NBP) reverted in 1989 to its traditional role as a central bank operating in a market economy. The Act on the National Bank of Poland was adopted in January 1989 and last amended in December 2003.

The decision-making bodies of the NBP are the president of the NBP, the Monetary Policy Council and the Management Board. The Monetary Policy Council, chaired by the NBP president, is responsible for formulating Poland's monetary policy.

Objectives

The secondary objective of the NBP (Article 3(1); see also Article 9(3)) refers to the economic policies of the government. It should moreover make reference to the general economic policies in the Community, with the latter taking precedence over the former.

Independence

The Act on the National Bank of Poland contains some imperfections as regards independence: no reference to the NBP's independence is included, while the Act emphasizes the co-operation between the NBP and the state authorities (Articles 21 and 23). Moreover, Article 69 provides for the submission of the NBP's annual accounts for approval by the Council of Ministers.

As regards personal independence, some imperfections subsist. The grounds for dismissal of the NBP president and of the members of the Monetary Policy Council (Articles 9(5) and 13(5) of the Act and Article 198 of the Constitution of the Republic of Poland) could be brought in line with those of Article 14(2) of the ESCB/ECB.

Integration in the ESCB

The incompatibilities in the NBP Act in this area are linked to the following ESCB/ECB tasks:

- the absence of a general reference to the NBP as an integral part of the ESCB and to its

subordination to the ECB's legal acts (Article 2 contains an imperfection);
- the definition of monetary policy (Articles 12(1), 12(2) and 23(1)2; Articles 3(2) and 21(1) of the Act contain an imperfection);
- the conduct of foreign exchange operations and the definition of foreign exchange policy (Articles 3(2)3, 24(1)-(2) and 52);
- the holding and managing of foreign reserves (Article 52; Article 3(2)2 contains an imperfection);
- the right to authorise the issue of banknotes and the volume of coins (Articles 4 and 33);
- the definition of the monetary unit (Articles 31 and 32);
- the monetary functions, operations and instruments of the ESCB (Articles 12(2)1-3, 12(2)6, 38-41, 42(4)-(7), 44-47).

Article 227 of the Polish Constitution does not reflect that monetary policy decisions as well as foreign exchange policies shall be adopted at EC level once Poland joins the euro area. Moreover, the NBP shall exercise its responsibility for issuing the national currency as part of the ESCB. The role of the Supreme Chamber of Control with regard to the NBP, as defined in Article 203 of Poland's Constitution, should be reduced, so as to ensure compliance with the provisions of Article 27 of the ESCB/ECB Statute.

2.4.8.2. Assessment of compatibility

As regards central bank integration into the ESCB at the time of euro adoption, legislation in Poland, in particular the Act on the National Bank of Poland and the Constitution of Poland, is not fully compatible with Article 109 of the Treaty and the ESCB/ECB Statute.

In addition, the correction of some residual imperfections is recommended. In particular, imperfections subsist as regards the NBP's objectives as well as institutional, financial and personal independence.

2.4.9. Slovenia

2.4.9.1. Current legal situation

Introduction

The Bank of Slovenia was established in June 1991, when the Bank of Slovenia Act was adopted. The initial Act was replaced by a totally new Act adopted on 3 July 2002.

The decision-making bodies of the Bank of Slovenia are the Governing Board and the governor of the Bank of Slovenia. The Governing Board, chaired by the governor, is responsible for formulating Slovenia's monetary policy.

Objectives

Without prejudice to the primary objective of price stability, the Bank of Slovenia shall support the general economic policy and shall endeavour to safeguard financial stability (Article 4). The secondary objective should reflect the wording of Article 105(1) more accurately, while the third objective (safeguard financial stability) should be subordinated to the second one, as opposed to being at the same level.

Independence

No incompatibilities with the Treaty exist in this respect. The grounds for dismissal of the members of the Governing Board of the Bank of Slovenia (Article 39(1)) should however be aligned to those mentioned under Article 14(2) of the ESCB/ECB Statute. Moreover, the nature of the Government's involvement as regards the management of the foreign exchange assets (Article 27(2)) requires further clarification.

Integration in the ESCB

The incompatibilities in this area are linked to the following ESCB/ECB tasks:
- the holding and managing of foreign reserves (Article 58(2));
- the right to authorise the issue of banknotes and the volume of coins (Articles 8, 9 and 58(2));
- the monetary functions, operations and instruments of the ESCB (Articles 15, 16, 17(2), 18(2), 19, 20, 45; Article 58(1) contains an imperfection).

2.4.9.2. Assessment of compatibility

As regards central bank integration into the ESCB at the time of euro adoption, legislation in Slovenia, in particular

the Bank of Slovenia Act, is not fully compatible with Article 109 of the Treaty and the ESCB/ECB Statute.

In addition, the correction of some residual imperfections is recommended. In particular, imperfections subsist in respect of the Bank's objectives as well as in the field of personal and institutional independence.

2.4.10. Slovakia

2.4.10.1. Current legal situation

Introduction

The National Bank of Slovakia (NBS) was established on 1 January 1993, following the division of the State Bank of Czechoslovakia. The Act on the Bank of Slovakia (Act 506/1992) was adopted on 18 November 1992, and subsequently amended by a new Act entering into force in May and July 2001 (for two paragraphs). The Act was last amended by an amendment to the Foreign Exchange Act of December 2003.

The supreme governing body of the NBS is the Bank Board. Chaired by the governor of the NBS, the latter determines the monetary policy, the implementation instruments and decides on the NBS's monetary policy measures.

Objectives

Article 12(1) of the Act on the SNB should include a reference to the secondary objective of the ESCB (Article 105(1) of the Treaty).

Independence

No incompatibilities with the Treaty exist in this respect. However, the grounds for dismissal of the members of the Bank Board (Article 7(9)) should be aligned with those mentioned under Article 14(2) of the ESCB/ECB Statute. The right for the Parliament to oblige the NBS to modify its annual report (Article 38(3)) constitutes a further imperfection in the area of central bank independence.

Integration in the ESCB

The incompatibilities in this area are linked to the following ESCB/ECB tasks:

- the absence of an explicit and general reference to the subordination of the NBS to the ECB's legal acts (Article 2(2) contains an imperfection);
- the legislative power of the ECB/EC Council (Articles 6 (2)a and 30);
- the definition of monetary policy (Articles 2(1)a, 6(1), 6(2)a and 18);
- the conduct of foreign exchange operations and the definition of foreign exchange policy (Articles 4(2) and 28a);
- the right to authorise the issue of banknotes and the volume of coins (Articles 6(2)e, 16(1) and 17; Article 2(1)b contains an imperfection);
- the definition of the monetary unit (Article 15);
- the monetary functions, operations and instruments of the ESCB (Articles 18, 20, 21, 23, 24(1)-(2) and 27(1));
- the financial provisions related to the ESCB (Article 39(2)).

2.4.10.2. Assessment of compatibility

As regards central bank integration into the ESCB at the time of euro adoption, legislation in Slovakia, in particular the Act on the National Bank of Slovakia, is not fully compatible with Article 109 of the Treaty and the ESCB/ECB Statute.

In addition, the correction of some residual imperfections is recommended. In particular, imperfections subsist as regards the Bank's objectives and its independence (both personal and institutional).

2.4.11. Sweden

2.4.11.1. Current legal situation

Introduction

The position of the Riksbank as a central bank dates back to 1897 when the first Riksbank Act was accepted concurrently with a Law giving the Riksbank the exclusive right of issuing banknotes. The legal basis for its establishment is contained in both the Instrument of Government (Swedish Constitution) and in the Sveriges

Riksbank Act adopted in 1985. The Sveriges Riksbank Act was last amended in 2002.

The decision-making bodies of the Riksbank are the General Council, the Executive Board and the governor. The Executive Board is in charge of decision-making on monetary policy. The respective competences of the Executive Board and the General Council are not explicitly specified in the Sveriges Riksbank Act.

Objectives

The secondary objective of the Riksbank Act (Chapter 1 Article 2) refers to promoting a safe and efficient payment system. A reference should be included to the general economic policies in the Community, which shall take precedence over the secondary objective.

Independence

The absence of detailed legislation in the field of profit distribution impinges on the financial independence of the Riksbank (Chapter 10 Article 4) and constitutes an incompatibility. The possibility for the Riksdag (the Swedish Parliament) of proceeding with exceptional transfers, without any safeguard clause ensuring that the Bank will keep the necessary means to fulfil the ESCB-related tasks, could jeopardise the ability of the Riksbank to carry out its monetary policy tasks.

As regards institutional independence, the prohibition of seeking or taking instructions only covers monetary policy issues, and not all ESCB-related tasks (Chapter 3 Article 2 of the Act, Chapter 9 Article 13 of the Instrument of Government).

Integration in the ESCB

The incompatibilities in this area in the Riksbank Act are linked to the following ESCB/ECB tasks:

- the absence of a general reference to the Riksbank as an integral part of the ESCB and to its subordination to the ECB's legal acts (Chapter 1 Article 1 contains an imperfection);
- the definition of monetary policy (Chapter 1 Article 2 and Chapter 6 Article 3);
- the conduct of foreign exchange operations and the definition of foreign exchange policy (Chapter 7 Article 1);
- the right to authorise the issue of banknotes and the volume of coins (Chapter 5 Articles 1 and 2);
- the definition of the monetary unit (Chapter 5 Article 1);
- the monetary functions, operations and instruments of the ESCB (Chapter 6 Article 6 and Chapter 11 Articles 1 and 2).

The integration requirement also implies the removal of incompatibilities in the Instrument of Government, notably in Chapter 9 Articles 12 (responsibility for general currency policy matters), 13 (responsibility for monetary policy decisions) and 14 (right to issue coinage and banknotes).

2.4.11.2. Assessment of compatibility

As regards central bank financial independence as well as central bank integration into the ESCB at the time of euro adoption, legislation in Sweden, in particular the Sveriges Riksbank Act and the Instrument of Government (the country's Constitution), continues not to be fully compatible with Articles 108 and 109 of the Treaty and the ESCB/ECB Statute.

In addition, the correction of some residual imperfections is recommended. In particular, an imperfection subsists both as regards the Bank's objectives and in the field of institutional independence.

Table 2.1.

Current situation in the eleven Member States in relation to legal compatibility

ESCB objectives *(numbers refer to EC Treaty articles)*	**CZ**	**EE**	**CY**	**LV**	**LT**	**HU**	**MT**	**PL**	**SI**	**SK**	**SE**
105(1) price stability				i							
105(1) secondary objective		i	i	i	i	i	i	i	i	i	i

X: incompatible provisions i: imperfections v: provisions requiring clarification

ESCB independence *(numbers refer to EC Treaty and ESCB/ECB Statute articles)*	**CZ**	**EE**	**CY**	**LV**	**LT**	**HU**	**MT**	**PL**	**SI**	**SK**	**SE**
Monetary financing and privileged access											
101(1) prohibition of monetary financing						v	v	v		v	
101(1) reference to all bodies, in particular EC and other public institutions											
101(1) reference to special funds and Government's paper						v		v		v	
101(2) exception for public banks											
102 prohibition of privileged access											
Independence											
108 institutional independence - no instructions								i			i
108 inst. ind. - reference to members of decision making bodies											
108 inst. ind. - no approval, suspension, annulation, …	i								i	i	
108 inst. ind. - no censorship on legal grounds						i					
108 inst. ind. - no participation with a voting right											
108 inst. ind. - no ex-ante consultation											
14(2) personal independence in general		i									
14(2) term of office of governor											
14(2) term of office of others											
14(2) grounds for dismissal for governor	i	i		i		i		i	i	i	
14(2) grounds for dismissal for others	i	i		i		i		i	i	i	
14(2) judicial review for governor - competence of the ECJ											
14(2) judicial review for others	i										
14(2) conflicts of interest											
108 financial independence - means for the ESCB-related tasks											
108 fin. ind. - no consultation on NCB's budget											
108 fin. ind. - review of accounts								i			
108 fin. ind. - distribution of profits - safeguard clause											X
109 general legal convergence											

X: incompatible provisions i: imperfections v: provisions requiring clarification

Integration into ESCB *(numbers refer to EC Treaty and ESCB/ECB Statute articles)*	**CZ**	**EE**	**CY**	**LV**	**LT**	**HU**	**MT**	**PL**	**SI**	**SK**	**SE**
General											
110(1) legislative power of the ECB, EC Council	X	X								X	
110(3) legislative power of the ECB - sanctions		X									
14(3) full integration into the ESCB		i	i	X, i	X		i	i			i
14(3) acting in accordance with ECB guidelines & instructions		i	i	i		i	i	i		i	i
14(4) ECB veto against other activities											
Monetary policy: definition & implementation											
105(2) monetary policy/ESCB	X	i	X	X	X	X	X	X, i		X	X
12 monetary policy decision to the Governing Council	X	X	X	X	X	X	X	X		X	
Foreign exchange: policy & operations											
105(2) foreign exchange operations/ESCB						X	i	X		X	
111 i) exchange rate policy - EC Council	X	X	X	X	X	X	X	X		X	X
Holding & managing foreign reserves											
105(2) hold/manage forex reserves/ESCB								X			
105(3) Government's forex limited to working balances											
30 transfer of foreign assets to the ECB					X		X				
31 ECB approval and guidelines on operations above limits	X, i	X, i	i	X, i	X, i	X	X	i	X		
Euro banknotes & coins											
106(1) banknotes	X, i	X	X	X	X	X	X	X	X	X, i	X
106(2) i) coins ECB autorisation	X, i	X	X	X	X	X	X	X	X	X, i	X
106(2) ii) coins technical characteristics & denomination by EC Council	X	X	X	X	X	X	X	X	X	X	X
Reference to national currencies	X		X	X			X	X		X	X
Instruments of monetary control											
18(1) credit based on adequate collateral						X	X	X		X	
18(2) OMO/credit operations - ECB guidelines	X	X	X		X	X	X	X	X, i	X	
19(1) ECB role as regards minimum reserves	X	X	X	X	X	X	X	X	X, i	X	X
19(2) EC Council role, in particular sanctions	X	X	X	X	X		X	X	X, i	X	X
20 other instruments - ECB Governing Council/EC Council		X			X	X		X	X, i	X	
22 clearing and payment systems											
23 external operations											
Financial provisions											
26(1) financial year from 1/1 to 31/12											
26(4) ECB GC - standards for accounting and reporting for NCBs											
27(1) auditing - role ECB GC/EC Council	X	i		X		X	X			X	
27(2) role of the state audit office		i		X				X		X	
32-33 allocation of monetary income & profits to NCBs											
Other issues linked to integration											
105(2) promote payment system/ESCB											
105(4) ii) consultation of ECB											
105(5) ECB contribution to prudential supervision & financial system stability											
5(4) statistical role of ECB and EC Council											
6(2) ECB approval before participation in International Monetary Organisat.			i		X						
15(3) reporting commitments of the ECB											
38 professional secrecy - exemptions											

X: incompatible provisions   i: imperfections   v: provisions requiring clarification

Source: Commission Services

3. PRICE STABILITY

3.1. The price stability criterion

3.1.1. Treaty provisions

The price stability criterion is defined in the first indent of Article 121(1) of the Treaty: "*the achievement of a high degree of price stability (...) will be apparent from a rate of inflation which is close to that of, at most, the three best performing Member States in terms of price stability*".

The protocol on the convergence criteria develops Article 121(1), by stipulating in Article 1 that a Member State is convergent in terms of inflation if it "*has a price performance that is sustainable and an average rate of inflation, observed over a period of one year before the examination, that does not exceed by more than 1.5 percentage points that of, at most, the three best-performing Member States in terms of price stability. Inflation shall be measured by means of the consumer price index on a comparable basis, taking into account differences in national definitions*".

Since national consumer price indices (CPIs) diverge substantially in terms of concepts, methods and practices, they do not constitute the appropriate means to meet the Treaty requirement that inflation must be measured on a comparable basis. To this end, the Council adopted on 23 October 1995 a framework regulation[19] setting the legal basis for the establishment of a harmonised methodology for compiling consumer price indices in the Member States. This process resulted in the production of the Harmonised Indices of Consumer Prices (HICPs), which have been used for assessing the fulfilment of the price stability criterion. HICPs are currently available for all Member States with a derogation, starting in 1996 for the index and hence in 1997 for annual rates of change.

19 Council Regulation (EC) No. 2494/95 of 23 October 1995 concerning harmonised indices of consumer prices (OJ L 257, 27.10.1995, pp. 1-4)

3.1.2. Inflation developments in relation to the reference value

As has been the case in past convergence reports, a Member State's *average rate of inflation* is measured by the percentage change in the arithmetic average of the last 12 monthly indices relative to the arithmetic average of the 12 monthly indices of the previous period. The *reference value* is calculated as the arithmetic average of the average rate of inflation of the three best-performing Member States in terms of price stability plus 1.5 percentage points.

Table 3.1

Inflation convergence - August 2004

(inflation, measured by the percentage change in the HICP) [(1)]

Three best performers	
FI	0.4
DK	1.0
SE	1.3
Reference value [(2)]	**2.4**
Member States below reference value	
LT	-0.2
SE	1.3
CZ	1.8
EE	2.0
CY	2.1
Member States above reference value	
PL	2.5
MT	2.6
SI	4.1
LV	4.9
HU	6.5
SK	8.4

(1) Measured by the arithmetic average of the latest 12 monthly indices relative to the arithmetic average of the 12 monthly indices of the previous period.
(2) Unweighted aritmetic average of the three best performers in terms of inflation plus 1.5 percentage points.

Over the 12 month period covering September 2003-August 2004, the three best-performing Member States in terms of price stability were Finland (0.4 percent), Denmark (1.0 percent) and Sweden (1.3 percent), resulting in a reference value of 2.4 percent[20]. For the purpose of calculating the reference value, countries with negative average inflation rates are not considered to be best performers in terms of price stability. Lithuania, for which the average rate of inflation was -0.2 percent, was therefore not included as a best performer.

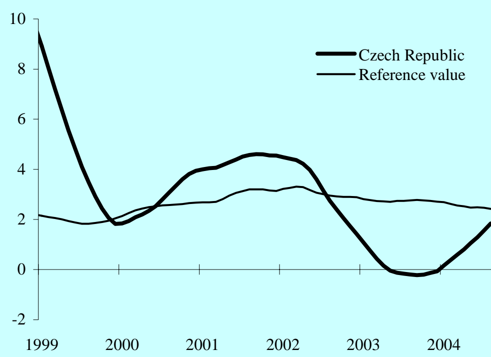
Six out of the eleven Member States with a derogation exceeded the reference value in August 2004: Poland (2.5 percent), Malta (2.6 percent), Slovenia (4.1 percent), Latvia (4.9 percent), Hungary (6.5 percent) and Slovakia (8.4 percent) (see Table 3.1).

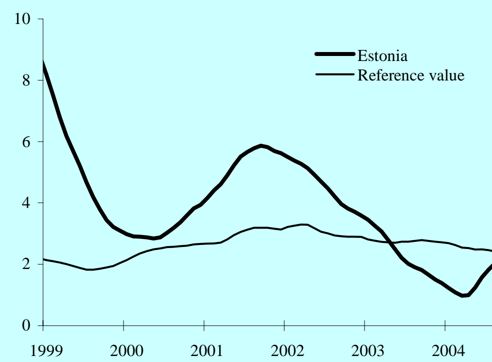
For comparison, the highest inflation rate in the euro area was Greece (3.1 percent) and the euro area 12 month average over the same period was 2.1 percent.

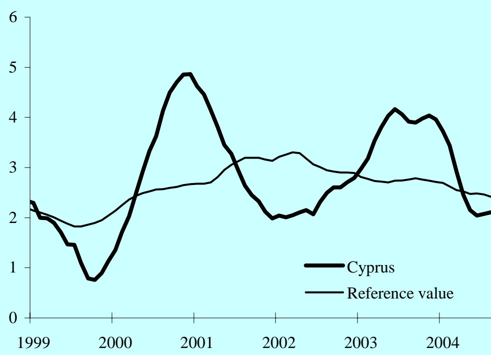
The reference value has been consistently above the euro area average. Over the period January 1999 - August 2004, the reference value – based on EU-15 until April 2004 and EU-25 afterwards – fell to a low of 1.8 percent in July 1999 and peaked between February and April 2002 at 3.3 percent.

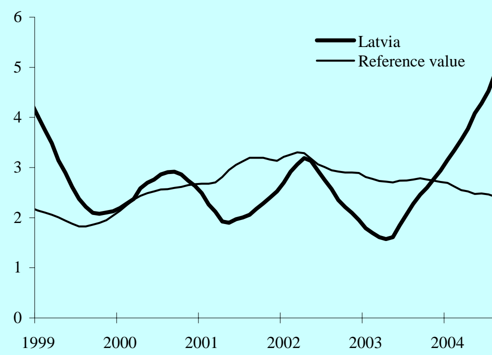
20 The reference values used in the 1998, 2000 and 2002 Convergence Reports were 2.7, 2.4 and 3.3 percent, respectively.

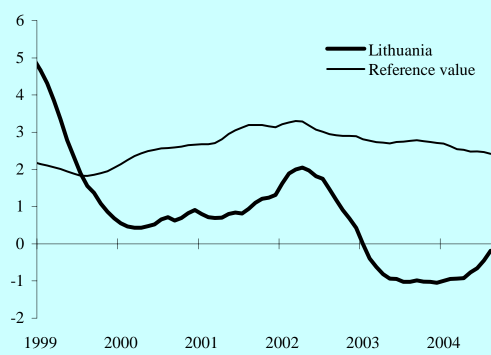
Graph 3.1: **Comparison of Member States' average inflation rates (HICP) (1) with reference value (2)**

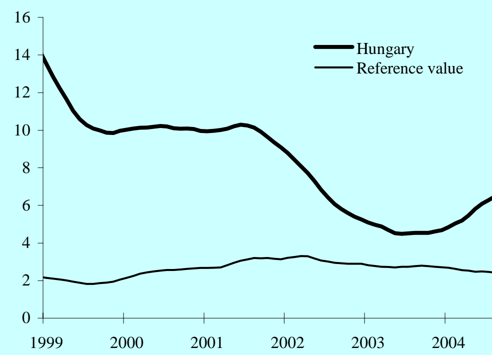












Graph 3.1: **Comparison of Member States' average inflation rates (HICP) with reference value** *(continued)*

[(1)]Measured by the percentage change in the arithmetic average of the latest 12 monthly indices relative to the arithmetic average of the 12 monthly indices of the previous period.

[(2)]Unweighted arithmetic average of the three best performers in terms of inflation plus 1.5 percentage points.

Source : Commission services

Table 3.2

Evolution of the inflation reference value [1]

	Three best performers [2]	Reference value [3]	Euro area [2]
July 2003	BE, DE, UK	2.7	2.1
August 2003	BE, DE, UK	2.8	2.1
September 2003	BE, DE, AT	2.8	2.1
October 2003	DE, AT, FI	2.8	2.1
November 2003	DE, AT, FI	2.7	2.1
December 2003	DE, AT, FI	2.7	2.1
January 2004	DE, AT, FI	2.7	2.1
February 2004	DE, AT, FI	2.6	2.0
March 2004	DE, AT, FI	2.5	1.9
April 2004	DE, AT, FI	2.5	1.9
May 2004	CZ, DK, FI	2.5	2.0
June 2004	CZ, DK, FI	2.5	2.0
July 2004	DK, FI, UK	2.5	2.1
August 2004	DK, FI, SE	2.4	2.1

(1)EU-15 until April 2004; EU-25 from May 2004 onwards.
(2)Measured by the percentage change in the arithmetic average of the latest 12 monthly indices relative to the arithmetic average of the 12 monthly indices of the previous period.
(3)Unweighted arithmetic average of the three best performers in terms of inflation plus 1.5 percentage points.

Source: Commission services.

3.2. Horizontal analysis of price developments

3.2.1. Medium-term developments

The main factors that have affected inflation developments in a medium term perspective in the eleven Member States that are assessed in this report vary considerably. Two country groups can be distinguished. One group consists of the eight countries that over the last 15 years were engaged in a transition from a centrally-planned to market-based economy. Such a transition implied the implementation of a series of profound political, institutional and economic structural changes. A second group is formed by those Member States that have longer-established market economies, i.e. Cyprus, Malta and Sweden.

Member States from Central and Eastern Europe

Over the last decade and a half the new Member States from Central and Eastern Europe achieved remarkable progress in terms of disinflation and convergence towards price stability. Inflation declined from sometimes three to four-digit levels in the early 1990s to in all cases single-digit levels in recent years.

The disinflation process in the eight new Member States from this region took place in different stages. In the early stages of transition, roughly 1990-1992, almost all of these countries experienced bouts of very high inflation linked to the initial liberalisation of prices and trade as well as the exchange rate depreciations that accompanied the beginning of the transformation of their economies. The size of the initial inflation surge varied across countries, reflecting *inter alia* the scale of the inherited distortions and the timing and design of the individual stabilisation programmes. On the basis of non-harmonised data, annual average rates of consumer price inflation in 1992 reached around 1000 percent in the Baltic countries, while inflation peaked earlier in most other countries, with annual average consumer price inflation figures between 500 and 600 percent in Poland and Slovenia in 1990. In 1991, consumer price inflation was around 60 percent in what is now the Czech Republic and Slovakia and around 35 percent in Hungary.

Between 1993 and 1997, annual inflation was reduced to more moderate rates, reflecting a clear policy orientation towards the achievement of nominal stability. While in some countries inflation declined steadily to single-digit levels (essentially the Baltic States and the Czech Republic), other countries – in particular Hungary and Poland - were faced with more persistent inflation rates. In 1997, the first year for which HICP inflation data are available for all new Member States, the annual average HICP inflation rate for the new Member States from Central and Eastern Europe taken together stood at close to 13 percent[21], compared to about 1½ percent in both the euro area and the EU. The highest inflation rate was observed in Hungary (18.5 percent), followed by Poland (15.0 percent) and Estonia (9.3 percent), while the lowest inflation rates were observed in Slovakia (6.0 percent) and the Czech Republic (8.0 percent).

During 1997 and 1999, strong exogenous shocks contributed to further disinflation. The Russian crisis of 1998 contributed to a weakening of economic activity and resulted in the emergence of excess agricultural stocks in many of the new Member States, leading to a sharp drop in food prices. This period was also characterised by falling and very low world oil prices as well as generally falling inflation to historically low levels in the EU. The average HICP inflation rate for the eight Central and Eastern European new Member States was nearly halved, falling from an annual average rate of nearly 13 percent in 1997 to about 6½ percent in 1999. The largest drop was registered in Hungary (8.5 percentage points), followed by Lithuania (8.1 percentage points) and Poland (7.8 percentage points). The only country where inflation increased over this period was Slovakia, with inflation rising from 6.0 percent in 1997 to 10.4 percent in 1999. The lowest inflation rates in that year were registered in Lithuania (0.7 percent), the Czech Republic (1.8 percent) and Latvia (2.1 percent).

The period between 1999 and 2001 witnessed a pick-up in inflation in most of these countries. For the group as a whole, HICP inflation increased from an average of about 6½ percent in 1999 to nearly 9 percent in 2000. The pick-up of inflation in many of these countries reflected the substantial increases of world oil prices, the recovery in global economic activity and, in some cases, the impact of currency depreciation. In the case of Poland, inflationary pressures were compounded by rising food prices and an increase in excise duties on fuel in the course of 2000. In Slovenia, the external inflationary impulses were compounded by the introduction of VAT in 1999. Although also increasing, inflation rates in the Baltic countries and the Czech Republic were among the lowest in the group. In Hungary, inflation remained stable at around 10 percent in 1999-2000.

From 2001 onwards, inflation in most of the Central and Eastern European new Member States resumed a downward path, reaching levels similar or even lower than in the EU-15 Member States. These developments could be seen as a resumption of the disinflation process started in the 1990s, which in many cases was temporarily interrupted by the oil price increases of 1999 and 2000. Common factors

21 The average inflation rate for the new Member States was calculated using HICP country weights, which makes it comparable to the regularly published figures for the euro area and the EU-15 average inflation rates.

to the fall in inflation in 2001 and 2002 included the unwinding of the previous hikes in energy prices, a marked deceleration in global and euro area economic activity and a strengthening of currencies. In a number of cases the stance of monetary policy was also instrumental in reducing inflation, by reducing inflation expectations and offsetting the impact of other inflationary sources.

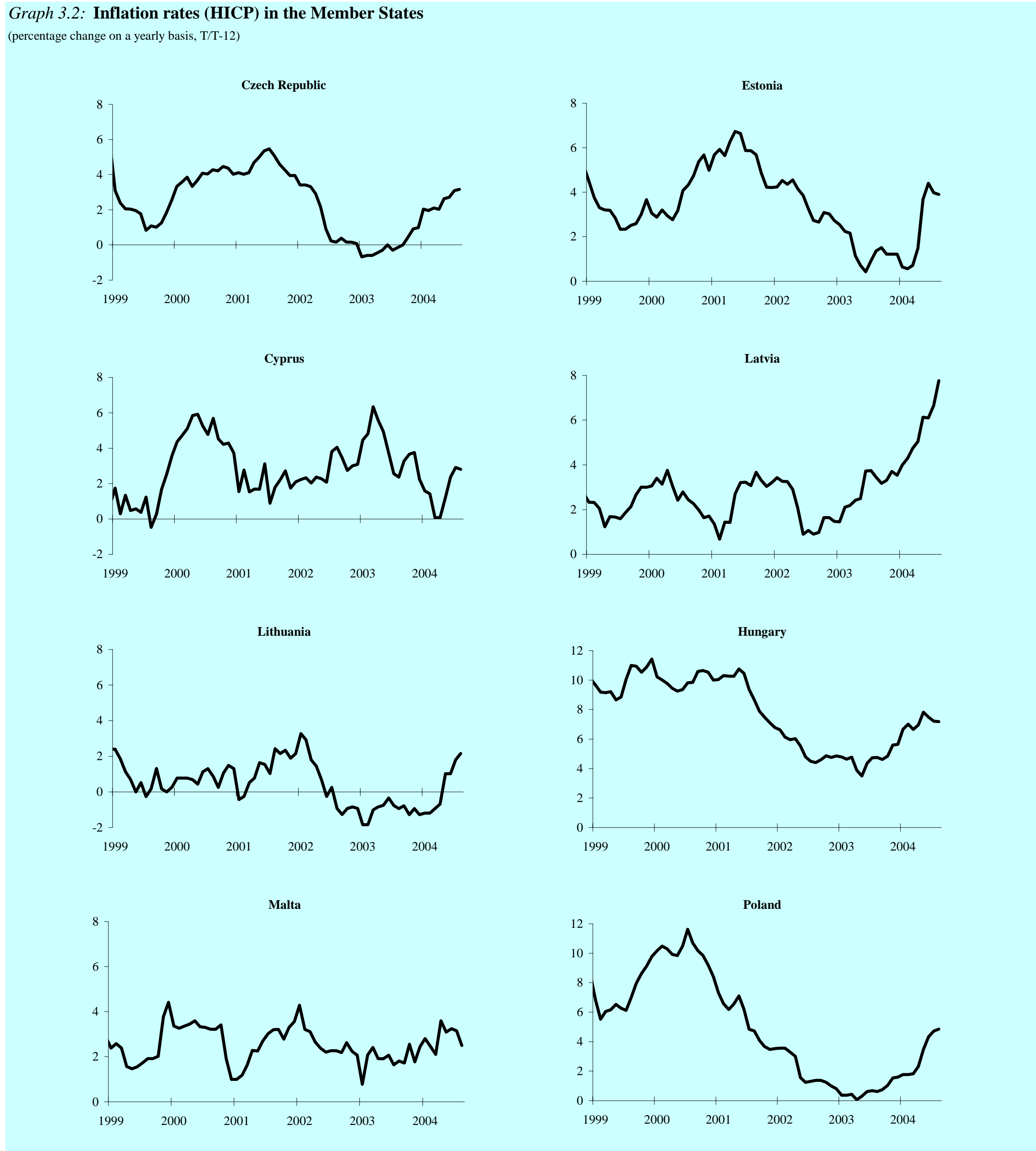
Malta, Cyprus and Sweden

Inflation developments since the early 1990s were less marked in the two other new Member States, *Malta* and *Cyprus*. Inflation in both countries moved within a corridor of fairly low levels over the whole time period. Based on non-harmonised data, consumer price inflation averaged 4.5 percent in Cyprus and 3.0 percent in Malta in 1990. Inflation in Cyprus subsequently increased and peaked at 6.5 percent in 1992, while in Malta it fell to 1.8 percent in 1992. Over the next three years, inflation again moved in opposite directions, falling to an average rate of 2.6 percent in 1995 in Cyprus and rising to 4.0 percent in Malta in 1995. By 1997, the first year for which HICP data are available for all new Member States, the annual average inflation rate stood at 3.3 percent in Cyprus and 3.9 percent in Malta. At those levels, HICP inflation rates in these two countries were the lowest of all ten new Member States in that year.

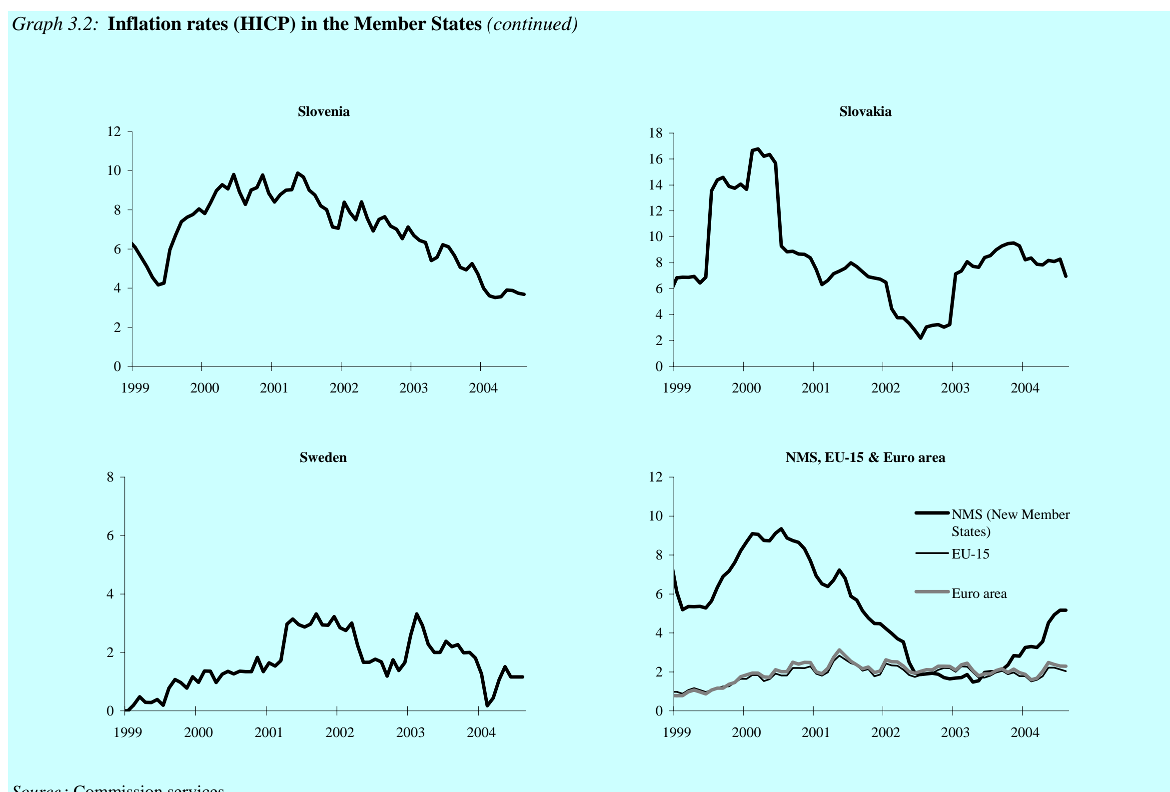
During the 1997-1999 period, inflation decelerated to 1.1 percent in the case of Cyprus and to 2.3 percent in Malta, helped by low oil prices and a general disinflation move in the EU and other industrialised economies. In 2000, reflecting the impact of rises in oil prices and the depreciation of the euro, inflation rose to 4.9 percent in Cyprus and to 3.0 percent in Malta. After receding in the following year, inflation steadily picked-up again in Cyprus to an annual average rate of 4.0 percent in 2003, associated with increases in VAT and excise duties and rising food and fuel prices, while in Malta HICP inflation gradually slowed to an annual average rate of 1.9 percent in 2003.

Following sustained periods of high inflation in both the 1970s and the 1980s, *Sweden* achieved a successful reduction in the inflation rate during the first half of the 1990s. The establishment of a stability-oriented macroeconomic policy framework, including an inflation targeting regime for monetary policy, following the economic crisis in Sweden at the beginning of the 1990s, contributed to this achievement. From an annual average rate of around 10 percent in 1990, HICP inflation fell to levels substantially below 2 percent in the second half of the 1990s. While Sweden has had an explicit inflation target for monetary policy and a flexible exchange rate regime since 1992, the commitment to price stability as the objective of monetary policy was further underlined by the new legislation on the status of the Riksbank that came into force in 1999. After rising to an annual average rate of 2.7 percent in 2001, HICP inflation fell to 2.0 percent in 2002, reflecting the adverse impact on economic activity from the global slowdown and the easing of strains on productive capacity. HICP inflation stood at 2.3 percent in 2003.

Graph 3.2: **Inflation rates (HICP) in the Member States**
(percentage change on a yearly basis, T/T-12)



Graph 3.2: **Inflation rates (HICP) in the Member States** *(continued)*



Source : Commission services

3.2.2. Recent trends

The annual rate of HICP inflation (as measured by the change in the monthly HICP index from 12 months earlier) in most of the Member States examined in this report followed a U-shaped pattern over the last 2½ years. The downward trend of HICP inflation that started in 2001 continued in most countries throughout 2002, sometimes also in the first part of 2003. Subsequently, inflation started to pick up, with a marked acceleration in 2004. The exceptions to this pattern were Cyprus, Slovenia and Sweden.

Developments in 2002 and 2003

In the new Member States, HICP inflation fell on average from 4.2 percent in January 2002 to a low of 1.6 percent in December of the same year. In most cases, the deceleration of inflation in 2002 was the continuation of the downward path started one year earlier. The three countries with the highest inflation rates in January 2002 were Slovenia (8.4 percent), Hungary (6.6 percent) and Slovakia (6.5 percent), while the countries with the lowest inflation rates were Cyprus (2.2 percent), Lithuania (3.3 percent) and Latvia and the Czech Republic (both 3.4 percent). A year later, in January 2003, the highest inflation rates were found in the same countries, with Slovakia having the highest rate (7.1 percent) followed by Slovenia (6.7 percent) and

Hungary (4.8 percent). At the opposite end, Poland reported the lowest inflation rate in January 2003 (0.4 percent), while the annual rate of change of consumer prices was actually negative in the Czech Republic (-0.7 percent) and Lithuania (-1.8 percent). These three countries, together with Malta, were also those that registered the largest drop in inflation during 2002 - in excess of 3 percentage points.

During the first months of 2003 inflation for this group of countries taken together remained at historically low levels, before dropping further to 1.5 percent in April. The April 2003 figure was also around ½ percentage point below the annual inflation rate registered for the euro area and the EU in that month.

By the summer of 2003, average HICP inflation in new Member States had risen to 2.0 percent. The drought across the continent damaged harvests and rising food prices put strong upward pressure on overall inflation. In addition, adjustments to VAT and excise taxes and further liberalisation of administered prices also provided inflationary impetus in some countries. Accordingly, a marked acceleration was observed in the final months of that year, with average HICP inflation reaching 2.8 percent in the year to December 2003. In terms of annual averages, HICP inflation in the new Member States ended up at 2.1 percent in 2003. The latter figure compares with the annual average rate of 2.1 percent registered in the euro area in the same year and 2.0 percent for the EU-15.

Developments in 2004

Average HICP inflation in the new Member States continued on an upward path throughout 2004, starting the year at 3.3 percent and rising to 5.2 percent in August. This latter figure compares to an annual rate of 2.3 percent in the euro area in the same month. Adjustments to tax systems to make them compliant with EU requirements, in particular upward adjustments to VAT and excise tax rates, contributed to this increase. Further liberalisation of administered prices also appears to have contributed significantly to inflation in several countries. While increases in inflation due to such changes are normally temporary, their large estimated impact raised some concerns as to possible second-round effects. In the spring of 2004, a common source of further upward pressure on HICP inflation came from developments in energy prices, reflecting the increase in world oil prices to historically high levels.

In January 2004, Slovakia (8.2 percent), Hungary (6.7 percent), Slovenia (4.0 percent) and Latvia (4.0 percent) reported the highest inflation rates. The lowest inflation rates in January 2004 were registered in Poland, Cyprus and Estonia (1.8 percent, 1.6 percent and 0.6 percent, respectively), while prices continued to fall in Lithuania (-1.2 percent).

The relative positions changed little by August 2004, but most countries reported higher inflation rates. Latvia, Hungary and Slovakia remained the countries with the highest inflation rates (7.8 percent, 7.2 percent and 7.0 percent), while the lowest inflation rates were observed in the Czech Republic, Cyprus, Malta and Lithuania (3.2 percent, 2.8 percent, 2.5 percent and 2.2 percent). HICP inflation more than doubled in Estonia, rising from 1.5 percent in April to 3.9 percent in August, thereby taking this country out of the group with the lowest inflation rates. The strong pick-up was triggered primarily by increases in VAT and excise duties as well as price hikes in certain food items following the introduction of the Common Agricultural Policy. Inflation rose sharply also in Lithuania, where it jumped from -0.7 percent in April to 1.0 percent in May and 2.2 percent in August, ending a period of nearly two years of deflation. The upsurge was induced by significant increases in prices of food, tobacco products, fuel and health care as well as the abolition, required by EU accession, of a reduced VAT rate on residential heating.

The exceptions to the common U-shaped pattern described above were Cyprus, Slovenia and Sweden. Having bottomed out already in 2001, inflation in Cyprus picked up since mid-2002, reflecting the impact of increases in the VAT rate and excise duties. After another acceleration at the beginning of 2003 that resulted from a further VAT hike and

from surges in the energy and food prices, inflation in Cyprus embarked on a downward path that culminated with consumer prices rising by just 0.1 percent in March and April 2004. In the following months inflation in Cyprus jumped sharply up to 2.9 percent in July and 2.8 percent in August, owing mainly to higher prices for food and fuel. HICP inflation in Slovenia was on a broadly uninterrupted downward path since early 2001. In March 2004 inflation reached a low at 3.5 percent. Reflecting higher prices for petroleum products it rose gradually since to stand at 3.7 percent in August 2004. In Sweden, the annual rate of HICP inflation fell from around 3 percent in the first months of 2002 to 1.2 percent in September of that year. From October onwards, under the influence of strong rises in energy prices, inflation embarked on an upward path, peaking at 3.3 percent in February 2003. Subsequently it hovered around 2.0 percent for the rest of the year. The unwinding of the energy price hikes one year earlier let inflation in Sweden drop to 0.2 percent in February 2004. Inflation rose gradually since and stood at 1.2 percent in August 2004.

3.3. Convergence towards price stability

The progress in terms of disinflation in the new Member States has resulted in considerable convergence towards price stability. From the early 1990s to the middle of the decade, the spread between the new Member State with the highest inflation rate and the one with the lowest rate declined from three-digit levels to close to 40 percentage points. The unweighted standard deviation, a measure of dispersion less affected by outliers, declined from three-digit levels in the early 1990s to around 15 percentage points in 1995. By 1997, the first year when HICPs are available for all new Member States, the spread between the highest and lowest inflation rates in the new Member States was down to 15 percentage points, while the unweighted standard deviation declined to 5 percentage points. Progress with convergence towards a low inflation environment continued during the following years, with a temporary interruption due to developments in 1999-2000. A historically low degree of inflation divergence was reached in 2002, when the spread between the highest and the lowest inflation rates in the new Member States stood at 7 percentage points, while the unweighted standard deviation was merely 2 percentage points. The pick-up of inflation in 2003 in many new Member States led to an increase in inflation divergence. The spread between the highest and the lowest inflation rates in this group of countries rose to 10 percentage points, while the unweighted standard deviation rose to 3 percentage points[22].

3.4. Underlying factors and sustainability of inflation performance

The Treaty not only requires Member States to have achieved a high degree of price stability but also calls for a price performance that is sustainable (Protocol on the convergence criteria). The requirement of sustainability aims at ensuring that the degree of price stability and inflation convergence achieved in previous years will be maintained after adoption of the euro. This implies that the satisfactory inflation performance must essentially be due to the adequate behaviour of input costs and other factors influencing price developments in a structural manner, rather than reflecting the influence of temporary factors, such as a fall in indirect taxes or import price developments.

3.4.1. Unit labour costs, wages and productivity developments

Developments in unit labour costs take on particular importance in the inflation process. They are the result of trends in labour productivity and nominal compensation per head. The former reflects more medium-term supply side factors (such as technological progress, the level of capital deepening and changes in the quality of labour) but might also be affected by cyclical developments.

22 Although starting from a lower level, euro area Member States also achieved a remarkable degree of convergence in consumer price inflation developments over the 1990s. The spread between the Member States with the highest and lowest headline inflation rates fell from close to 20 percentage points in the early 1990s to spreads of less than 2 percentage points in the period 1997-1999. The unweighted standard deviation followed a similar path, falling from over 5 percentage points in the early 1990s to historical lows of less than one percentage point in 1999.

Table 3.3
Labour costs

(percentage change, total economy)

	Nominal compensation per employee					Labour productivity					Nominal unit labour costs				
	1998-2000(1)	2001-2003(1)	2002	2003	2004(2)	1998-2000(1)	2001-2003(1)	2002	2003	2004(2)	1998-2000(1)	2001-2003(1)	2002	2003	2004(2)
CZ	7.5	6.7	6.2	6.4	4.0	3.3	3.1	0.0	7.0	4.3	4.1	3.6	6.2	-0.6	-0.3
EE	13.4	8.9	10.2	8.9	8.9	7.8	5.2	5.6	4.3	5.5	5.3	3.6	4.3	4.4	3.2
CY	4.0	3.0	4.4	0.0	3.0	3.0	1.0	0.8	0.5	2.5	1.0	2.0	3.6	-0.5	0.4
LV	6.9	6.2	4.4	10.8	7.0	6.8	5.4	4.8	5.6	6.7	0.1	0.8	-0.4	4.9	0.3
LT	7.9	3.6	0.7	6.8	6.8	5.6	6.4	2.6	6.5	4.5	2.2	-2.5	-1.9	0.2	2.2
HU	11.6	14.4	12.1	15.5	8.5	2.6	2.7	2.9	2.1	3.4	8.7	11.4	8.9	13.2	5.0
MT	8.4	4.0	2.0	4.4	1.4	3.8	-0.2	1.8	1.7	-0.5	4.5	4.3	0.2	2.7	1.9
PL	9.4	6.8	2.0	5.0	4.7	5.3	3.5	3.7	5.0	6.5	4.0	3.3	-1.6	0.0	-1.7
SI	9.4	9.8	10.0	7.8	6.5	2.9	2.9	3.7	2.8	3.8	6.4	6.7	6.0	4.8	2.6
SK	10.7	8.5	9.9	9.3	6.5	4.3	3.5	5.5	1.9	3.9	6.1	4.8	4.1	7.3	2.5
SE	3.8	3.2	2.7	2.4	3.4	2.1	0.9	1.9	1.8	3.9	1.7	2.3	0.8	0.5	-0.5
Euro area	**2.1**	**2.7**	**2.7**	**2.6**	**2.3**	**1.1**	**0.4**	**0.4**	**0.5**	**1.7**	**0.9**	**2.3**	**2.3**	**2.1**	**0.6**
EU-25	3.8	2.5	3.0	1.0	3.4	1.7	0.8	0.8	0.8	2.1	1.3	2.5	2.3	2.1	0.8
EU-15	3.6	2.2	2.9	1.0	3.4	1.3	0.6	0.6	0.6	1.9	1.4	2.5	2.3	2.2	0.9

(1) Average annual percentage change
(2) Forecast

Source : Commission services

The latter reflects private agents' inflation expectations and thus serves as an important indicator, amongst others, of the credibility of the anti-inflationary policy pursued by the authorities and of the sustainability of the inflation performance.

Unit labour costs

Overall, in the eleven Member States that are assessed in this report, unit labour cost growth decreased substantially since the second half of the 1990s. While the unweighted average increase of unit labour costs was still over 11 percent in 1996, compared to double and triple-digit numbers in the early 1990s, it fell to some 3 percent in 2003. Despite this drop, numbers continue to differ substantially among the eleven Member States. In 2003, unit labour cost growth ranged between -0.6 percent and 13.2 percent, while it ranged between 0.6 percent and 5.7 percent in the euro area. For 2004, the growth rates of unit labour costs are expected to further converge.

In the recent period since 2001, the most spectacular developments were registered in Lithuania, where unit labour costs actually fell almost continuously between 2001 and 2003. Other Member States, such as Cyprus and Latvia, had more incidental experiences with negative annual growth rates. In Hungary, Slovenia and Slovakia, the growth rate of unit labour costs remained high, but is expected to decrease this year. In the Czech Republic, unit labour costs remained relatively high until 2002. This trend reversed in 2003 when the country experienced a decrease of unit labour costs. Unit labour costs in Sweden accelerated slightly faster than in the EU at the end of the 1990s until 2001 but increased at a slower pace since.

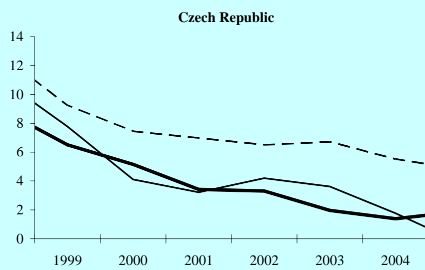
In comparison, while the rate of increase of unit labour costs at the end of the last century was subdued in the euro area (average annual growth rate of 0.9 percent), it increased in the period 2001-2003 to an average growth rate of 2.3 percent. This pick-up in unit labour costs was due to both higher wage increases and lower productivity growth. On the basis of the currently available information, unit labour cost growth in the euro area is expected to slow down in 2004, thereby remaining consistent with favourable inflation trends.

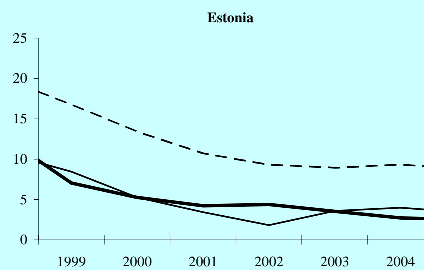
Labour productivity growth

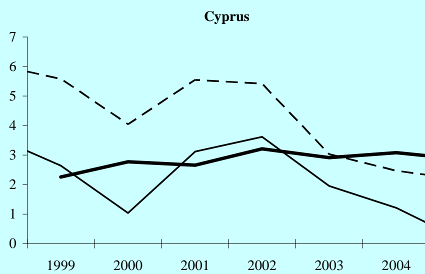
Developments in labour productivity growth showed a rather diverse pattern over the last 15 years in the Member States assessed. Throughout the 1990s, productivity growth decreased slightly in Hungary, Slovakia and Slovenia but accelerated somewhat in the Czech Republic, while it is hard to identify a clear trend in Poland. Lithuania and Latvia registered double-digit decreases of productivity in the first half of the 1990s but, together with Estonia, recorded a strong pick-up in productivity growth towards the end of the 1990s. In general, productivity growth in the three Baltic countries was sizeable since the end of the 1990s and has been the highest of all new Member States in past years with only occasional exceptions.

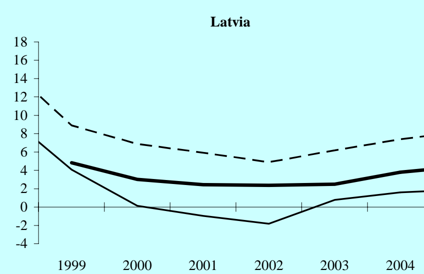
Graph 3.3: **Inflation and wage trends**
(three-year moving average of annual percentage change)

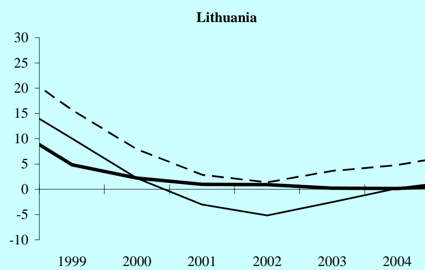
Nominal compensation per employee — Nominal unit labour cost — HICP

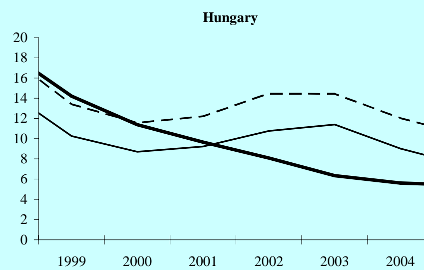


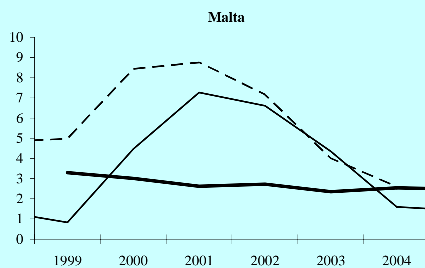


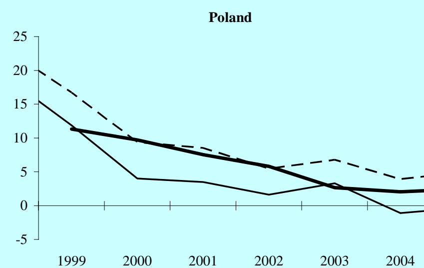




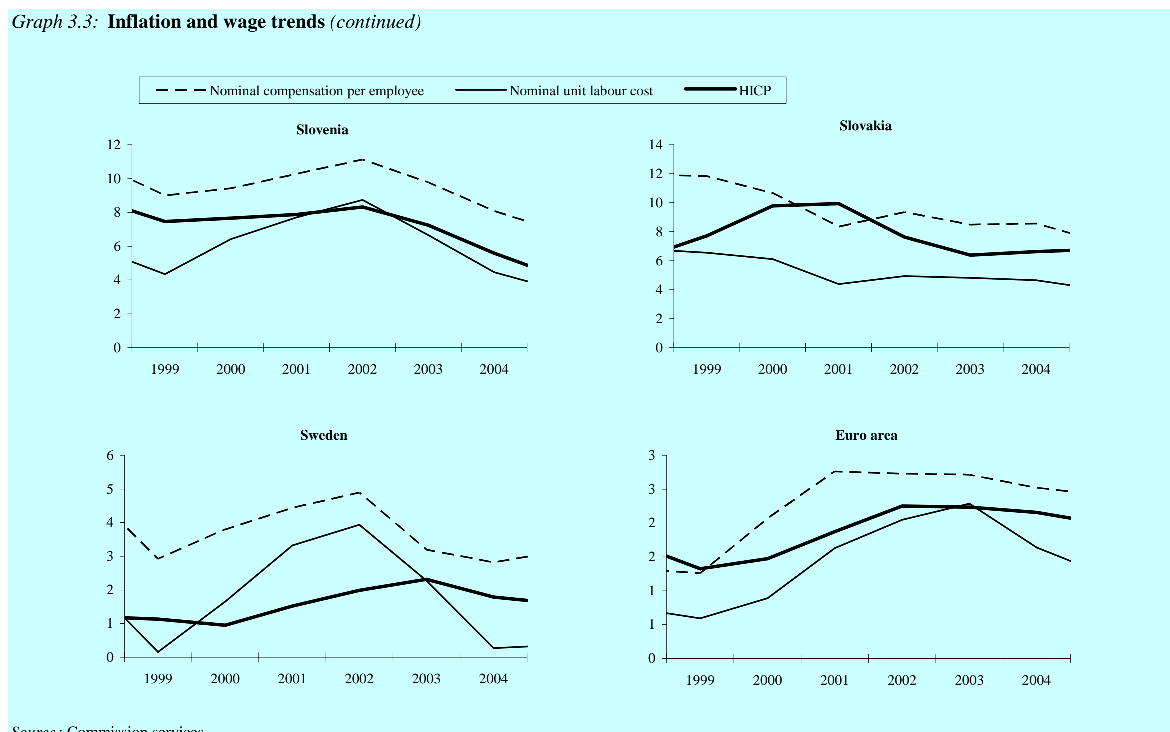








Graph 3.3: **Inflation and wage trends** *(continued)*



Source : Commission services

At the turn of the century, productivity growth on an annual basis reached record-highs in all Member States that are assessed in this report. Labour productivity growth (measured as the three-year average of annual growth rates) accelerated in the period between 2001 and 2003 compared to the period 1998 to 2000 in Lithuania (from 5.6 percent to 6.4 percent), Hungary (from 2.6 percent to 2.7 percent) and remained unchanged in Slovenia (at 2.9 percent). It slightly decelerated in the Czech Republic (from 3.3 percent to 3.1 percent), Estonia (from 7.8 percent to 5.2 percent), Cyprus (from 3.0 percent to 1.0 percent), Latvia (from 6.8 percent to 5.4 percent), Malta (from 3.8 percent to -0.2 percent), Poland (from 5.3 percent to 3.5 percent), Slovakia (from 4.3 percent to 3.5 percent) and Sweden (from 2.1 percent to 0.9 percent).

In comparison, at the end of the 1990s, productivity grew by 1.3 percent in EU-15 and by 1.1 percent in the euro area, but was more than halved between 2001 and 2003. In 2004, productivity growth in the new Member States is expected to continue to outperform productivity growth of the euro area. While the strong productivity growth may partly be attributable to the catching-up process, it is also partly due to the high level of labour shedding following the restructuring of some sectors, in particular manufacturing.

Nominal compensation per employee

Nominal wage developments have been an important element behind the remarkable fall in unit labour costs and the lowering of inflation in the Central and Eastern European new Member States. Although there are some data constraints for the start of the transition period, the available data show that all countries registered nominal wage growth

rates at two, and sometimes even three, digit levels in the first half of the 1990s. By the end of the 1990s, nominal compensation growth had been brought down to single-digit levels in the vast majority of the Central and Eastern European Member States. In comparison, since the second half of the 1990s, the growth rate of nominal compensation per employee in the euro area was below 3 percent.

A feature of the countries where moderate inflation rates were reached soon after the start of the transition period and where the disinflation process was sustained (Czech Republic, Estonia and Latvia) is that growth of nominal wages over the last five years substantially outpaced inflation. While these increases were almost offset in Latvia and in 2003 also in the Czech Republic by high labour productivity increases, productivity growth in Estonia stayed below nominal wage growth. In Poland, wage increases surged at the end of the 1990s but fell substantially in 2000 and2002 to one of the lowest levels of the Member States from Central and Eastern Europe. Hungary registered the highest wage increases of all Member States between 2001 and 2003 with an average annual increase of over 14 percent.

Cyprus registered moderate wage increases at the end of the 1990s. Since then, wage increases remained subdued and wage growth in Cyprus in 2003 was the lowest of the Member States assessed in this report. In Malta, wage increases between 2001 and 2003 moderated to one of the lowest levels of the Member States assessed. Wage developments in Sweden were on average some half percentage point higher than in EU-15 at the end of the 1990s. As labour productivity growth was also higher, the impact on inflation was limited. Between 2001 and 2003, wage increases were broadly in line with the EU-15 average.

Given the differences between the new Member States, it is difficult to provide a "one-size-fits-all" explanation for recent developments in compensation per employee. However, in many cases the trend towards moderate wage growth is likely to have resulted from several complementary factors. First, the much higher rate of unemployment in half of the New Member States compared to that in the EU15 might have contributed to lower labour cost pressures, which are increasingly seen as necessary for strong employment growth. This factor is thought to have been stronger in Poland, Slovakia and to a lesser extent the Baltic countries, where the unemployment rate is relatively high. Second, although the causality goes both ways, the sharp decline in inflation recorded in most countries in recent periods has led to a regular increase in wage earners' purchasing power, which is likely to have helped to moderate wage claims. In turn, moderation in wage claims may have reinforced the expectation of subdued inflation, rendering low negotiated pay rises more acceptable for wage earners. Third, wage negotiation systems are likely to have also played a role. The main level of collective wage negotiation in most new Member States with the exception of Cyprus, Slovakia and Slovenia is the enterprise rather than the sector or the inter-industry level. In general, the firms of a given sector are quite diverse in terms of productivity and employers are reluctant to delegate bargaining power to their sectoral organisations[23]. These decentralised wage bargaining systems have in all likelihood contributed to keeping labour costs growth in check and putting it broadly in line with local conditions and firm-specific productivity developments. Other labour market features conducive to wage moderation in these countries are related to trade unions and the coverage of collective bargaining. Average trade union membership in the new Member States is below the EU-15 level (21.9 percent of employees against 30.4 percent in the EU-15). The direct coverage of collective agreements in the new Member States is, on average, also significantly lower than in the EU-15[24]. Fourth, the absence of economy-wide indexation (apart from Cyprus and Slovenia) prevented temporary rises in inflation, as recorded in

23 See European Commission (2004), "The EU Economy: 2003 Review", *European Economy* No. 6.

24 However, the averages mask marked differences across countries. For instance, countries such as Cyprus and Malta have trade union membership rates of 70 percent and 65 percent, respectively. Similarly, direct coverage of collective bargaining ranges from 10 percent to 15 percent in Lithuania to almost 100 percent in Slovenia, where collective bargaining is mandatory.

Table 3.4
Import prices

(percentage change in the deflator of imports of goods and services, in national currency)

	1999	2000	2001	2002	2003	2004(*)
CZ	1.6	6.2	-2.6	-8.4	-0.5	1.3
EE	-0.2	6.2	4.6	0.4	-0.9	1.9
CY	2.6	8.0	1.8	-1.0	-1.6	1.8
LV	-4.4	6.7	0.7	4.2	5.8	5.0
LT	-4.0	4.3	-2.4	-3.9	-3.1	1.3
HU	5.5	12.4	2.4	-5.3	0.2	0.9
MT	0.2	12.4	-6.4	1.4	-3.8	3.3
PL	7.1	7.7	1.3	5.2	6.9	4.4
SI	1.5	13.8	6.2	2.4	2.0	2.9
SK	8.1	11.6	8.4	0.0	-3.5	-1.2
SE	1.1	4.8	4.0	0.0	-2.2	1.0
Euro area	**-0.2**	**8.5**	**0.8**	**-1.7**	**-1.3**	**0.7**
EU-25	-0.1	7.6	0.7	-1.7	-0.9	0.7
EU-15	-0.4	7.5	0.7	-1.7	-1.1	0.6

(*)Forecast

Source : Commission services.

Slovakia in 2000-2001, from automatically translating into wage push.

Looking at Sweden, the rise in compensation per employee growth in the 2000-2002 is likely related to the very low rate of unemployment (standing at around 4 percent in 2001-2002) as well as the significant rebound in inflation over the period. Since then, wage growth rate has decreased and broadly stabilised owing to the upturn in unemployment together with the decline in inflation recorded in 2003/2004.

3.4.2. Import prices

The economies of the eleven Member States that are assessed in this report have a high degree of openness and developments in import prices can thus play an important role in the domestic price formation. Changes in import prices are the result of several different factors, including changes in international prices and the value of the exchange rate, the geographical composition of imports, the price-setting behaviour of foreign suppliers and domestic demand conditions. In due course, changes in import prices are likely to feed through, at least partially, to final prices. For the purpose of the assessment of a country's inflation performance and of its sustainability, it is therefore relevant to examine whether and how external price developments have impacted on domestic inflation.

Between 1999 and 2001 import prices in the Member States assessed showed a common trend. The sharp acceleration of the growth rate of import prices in 2000 and the subsequent reversal were in many cases mainly a result of the oil price hike at the beginning of the century. Despite this common trend, growth rates of import prices varied quite substantially over the different countries over the last six years. In 1999, the annual increase of import prices ranged between 8.1 percent in Slovakia and -4.4 percent in Latvia. In 2003, the annual increase of import prices was the highest in Poland (6.9 percent) and the lowest in Malta (-3.8 percent). This diversity reflects not only the geographical composition of imports, the price-setting behaviour of foreign suppliers and domestic

demand conditions, but also different exchange rate regimes in the Member States.

In Estonia and Lithuania, the existence of a currency board contributed to low and sometimes negative import price inflation, thereby exerting a moderating impact on overall consumer price increases. As almost 70 percent of Estonia's imports is denominated in euro (the currency to which the kroon is pegged), exchange rate developments only have a limited direct impact on the prices of imported goods. In Lithuania, the restraining impact of import prices on inflation was reinforced by the fact that the peg was changed from the US dollar to the euro in 2002. Import prices thus declined in 2001, reflecting the dollar appreciation, as well as in 2002 and 2003, reflecting the subsequent euro appreciation. The stronger dependency on US dollar developments in Latvia contributed to the sharp increase in import price inflation in recent years following the depreciation of the dollar. This explains to some extent the increase of domestic inflation since 2002. In the Czech Republic, import prices decreased substantially between 2001 and 2003 reflecting a trend appreciation in effective terms, thereby exerting a restraining impact on domestic price pressure. In 2002, a sharp decline in import prices helped reduce inflation by offsetting unit labour cost growth.

Of the other four countries that experienced a substantial decline in inflation rates more recently (Hungary, Poland, Slovenia and Slovakia), Slovenia and Slovakia recorded relatively high increases of import prices in 2000 and 2001, as a result of higher commodity prices and depreciating currencies. The import price deflator was reduced to a more moderate level in the subsequent years when the effects of the oil price hike faded away. In Poland, import prices increased strongly between 1999 and 2003 with the exception of 2001, reflecting the delayed effects of a depreciation of the currency until 1998 and since 2002, as well as the effects of the oil price hike in 2000. Nevertheless, domestic inflation was reduced substantially since 2000, reflecting moderate wage increases and negative unit labour cost growth rates. Strategic pricing by importers and the credibility of monetary policy might explain the weak pass-through of the depreciation on inflation. Import price inflation in Hungary was low after 2000 and even negative in 2002, thereby partly offsetting the inflationary pressure from high unit labour cost increases and exerting a restraining impact on domestic prices.

In Cyprus, import price inflation increased in 2000 and 2001 but decreased between 2002 and 2003, showing a similar pattern as in other countries which pegged their currency to the euro. The fact that Malta pegged its currency to a basket in which the euro has a significant weight is reflected in the developments of import prices since the end of the 1990s. With over 12 percent, import price inflation in Malta in 2000 was one of the highest of all Member States assessed but slowed down markedly since.

Import prices in Sweden accelerated somewhat in 2000 and 2001, coinciding with the depreciation of the currency vis-à-vis the euro as well as in effective terms, which contributed to some upward pressure on inflation in particular in 2001. However, while the currency has been relatively stable vis-à-vis the euro since 2002, the effective exchange rate has shown an appreciating trend. This has contributed to falling import prices which in turn have contributed to keeping inflation low.

3.4.3. Balassa-Samuelson and other effects

The review of inflation developments since the early 1990s has shown a variety of factors at play in explaining the – until recently – higher inflation rates in a number of new Member States, in particular those engaged in the transition from planned to market economy. One factor is related to private consumption which has grown more rapidly than under central planning. The composition of consumption may also have changed, with an increase in spending on non-tradable goods, e.g. services, which may have been previously under-supplied. If productivity growth in the non-tradables sector was unable to meet increased demand, this overall increase and change in the composition of consumption may have given rise to an increase in the overall price level. Also, general government deficits have risen for a period. With government consumption likely to be weighted more towards non-tradable goods, this may have given rise to a jump increase in the domestic price level. Of course, price liberalisation has also contributed to inflationary

pressures. While prices of tradables have been liberalised early in the transformation process, some non-tradable goods have been sold below market prices for a more extended period and the completion of the process of deregulation of these administered prices may still affect the price index. Also, fundamental changes in tax systems, such as a shift towards indirect taxes, and the alignment of some prices (such as of agricultural products) in view of accession have had a temporary impact on price levels.

A frequently cited explanation in discussions on inflation performance in a number of new Member States is the Balassa-Samuelson hypothesis. Applied to the new Member States, it postulates that a Member State that is catching-up will face higher overall inflation than the euro area due to higher differentials of productivity growth between the tradable and non-tradable sectors of the economy compared to the euro area. In a two-sector economy - tradables and non-tradables (typically services) - prices in the tradables sector will be equalised to those of the partner country at the present exchange rate. Due to catching-up, productivity growth in the tradables sector is expected to be higher than in the more mature trading partner. As a result, there is room for wage increases in the tradables sector without loss of competitiveness. However, wage equalization pressures are likely to spill over to the non-tradables sector where productivity increases are smaller. Consequently, prices in the non-tradables sector are likely to increase resulting in an increase in the overall price index, an increase that is likely to be higher than the one in the more mature trading partner.

A number of authors have attempted to estimate the size of past Balassa-Samuelson effects in the former transition countries[25]. The bulk of the estimates points to an impact between 0 and 2 percent per year, the latter figure being similar to the effects reported for Spain and smaller countries in the euro area prior to EMU.

3.5. Concluding remarks

The new Member States from Central and Eastern Europe have gone a long way since the early 1990s in bringing down inflation. From inflation rates ranging in the hundreds, all countries achieved in recent years single-digit inflation levels and, as of July 2004, five out of the ten new Member States had inflation rates below the reference value. A clear policy orientation towards nominal stability has been key. Furthermore, an increased credibility of the resolve and the ability of monetary authorities to achieve price stability has contributed importantly to reducing inflation expectations. Unit labour cost increases were reduced substantially, reflecting a trend move towards wage moderation and increased productivity growth in most of the Member States assessed.

The challenge for the years to come will be to consolidate and further the disinflation process. In some cases, the good inflation performance has been helped by developments in exchange rates and other temporary factors. Moreover, inflation has been on an upward trend again since the trough of mid-2003. While this may be a reflection of temporary factors, such as higher energy prices or adjustments in taxation systems, care will have to be taken to avoid second-round effects.

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25 Results from these studies are summarised among others in W. Buiter and C. Grafe (2002), “Anchor, Float or Abandon Ship: Exchange Rate Regimes for the Accession Countries”, Banca Nazionale del Lavoro Quarterly Review, No. 221, pp. 1-32; B. Egertzs (2003), “Assessing Equilibrium Exchange Rates in CEE Acceding Countries: Can we have DEER with BEER without FEER? A Critical Survey of the Literature”, Oesterreichische Nationalbank Focus on Transition, 2/2003, pp. 38-106; M.A. Kovacs (2003), "How real is the fear? Investigating the Balassa-Samuelson effect in CEC5 countries in the prospect of EMU enlargement", paper presented at the conference on Monetary Strategies for Accession Countries, Budapest, February 2003; and D. Mihajlek and M. Klau (2003), “The Balassa-Samuelson effect in central Europe: a disaggregated analysis”, BIS Working Papers No. 143.

4. GOVERNMENT BUDGETARY POSITION

4.1. Convergence criterion

The convergence criterion dealing with the government budgetary position is defined in the second indent of Article 121(1) of the Treaty as "*the sustainability of the government financial position: this will be apparent from having achieved a government budgetary position without a deficit that is excessive as determined in accordance with Article 104(6)*". Furthermore, Article 2 of the Protocol on the convergence criteria states that this criterion means that "*at the time of the examination the Member State is not the subject of a Council decision under Article 104(6) of this Treaty that an excessive deficit exists*".

The convergence assessment in the budgetary area is thus directly linked with the excessive deficit procedure. For the main features of this procedure, which is specified in Article 104 of the Treaty and further clarified in the Stability and Growth Pact, see Box 4.1[26].

Focus of the excessive deficit procedure is the respect of the two criteria for budgetary discipline specified by Article 104(2) of the Treaty, namely on the government deficit and on the government debt. Continuous compliance with prudent targets for annual deficit and outstanding debt, in turn defined through simple numerical rules, is the approach chosen by the Treaty to make operational the underlying goal of fiscal sustainability.

The application of the excessive deficit procedure involves continuous monitoring of budgetary developments in each Member State. Failure by a Member State to fulfil the requirements under either criterion for budgetary discipline, namely on the government deficit and on the government debt, can lead to a decision by the Council on the existence of an excessive deficit, in which case the Member State concerned does not comply with the budgetary convergence criterion[27]. When a Member State has, in the view of the Council, corrected the excessive deficit, the Council abrogates its earlier decision. Both decisions are to be taken on the basis of recommendations from the Commission.

The state of convergence in the budgetary area is being assessed for the first time in the present report for the Member States that acceded to the EU on 1 May 2004. As regards Sweden, convergence has been assessed in previous convergence reports. Specifically, the Commission considered in the 1998 Convergence Report [28] that the excessive deficit situation in Sweden had been corrected. In the light of this assessment and in parallel with the adoption of the report, the Commission recommended to the Council that the decision on the existence of an excessive deficit in Sweden[29], taken immediately after accession to the EU, be abrogated. Acting on this recommendation, the Council abrogated its earlier decision on 1 May 1998[30]. Accordingly, in the 2000 and 2002 Convergence Reports[31], the Commission considered that Sweden fulfilled the criterion on the government budgetary position. This continues to be the case, as Sweden is not the subject of a Council decision on the existence of an excessive deficit.

Concerning the new Member States, the Commission services Spring 2004 forecasts, which took into account budgetary data reported in the context of the March 2004 notification[32], showed that six of them, namely the Czech

26 Information regarding the excessive deficit procedure and its application to different Member States since 2002 can be found at: http://europa.eu.int/comm/economy_finance/about/activities/sgp/edp_en.htm.

27 The definition of the general government deficit used in this report is in accordance with the excessive deficit procedure, as was the case in previous convergence reports. In particular, interest expenditure, total expenditure and the overall balance include net streams of interest expenditure resulting from swaps arrangements and forward rate agreements. Government debt is general government consolidated gross debt at nominal value.

28 COM (1998) 1999 final, 25.3.1998.

29 Council Decision of 10 July 1995.

30 OJ L 139, 11.5.1998, p. 19.

31 COM (2000) 277 final, 3.5.2000 and COM (2002) 243 final, 22.5.2002.

32 On 16 March 2004, Eurostat validated the deficit and debt figures reported by the new Member States, except for Latvia (see Eurostat News Release No 38/2004). Following improvement in the quality of

Republic, Cyprus, Hungary, Malta, Poland and Slovakia, recorded general government deficits above the 3 percent of GDP Treaty reference value in 2003, while, in Cyprus and Malta, the debt ratio also exceeded the Treaty reference value of 60 percent of GDP. In this connection, it should be noted that there are still some problems surrounding the quality and comparability of the budgetary data of the new Member States in spite of considerable efforts in the run-up to accession.

In view of this prima facie evidence for the existence of an excessive deficit, the Commission initiated the excessive deficit procedure on 12 May 2004 by preparing a report for these six new Member States. On 5 July 2004, on a recommendation from the Commission, the Council decided that an excessive deficit existed in these six Member States and addressed recommendations to each of them to correct this situation[33].

In conclusion, six of the eleven Member States under consideration in this report (namely the Czech Republic, Cyprus, Hungary, Malta, Poland and Slovakia) cannot be considered as fulfilling the criterion on the government budgetary position because they are the subject of a Council decision on the existence of an excessive deficit. The remaining five countries (Estonia, Latvia, Lithuania, Slovenia and Sweden) are not the subject of such a decision and hence are to be considered as fulfilling the budgetary convergence criterion. For Sweden, this confirms the assessment made in previous convergence reports.

The remaining sections of this chapter examine recent budgetary developments in the eleven Member States, including expected developments in 2004, and examine medium-term budgetary prospects as laid down in their convergence programmes. The final section presents this evidence for each Member State separately.

Latvian accounts, Eurostat was able to validate the figures in September 2004 (see Eurostat News Release No 117/2004).

33 The text of the Council decisions and recommendations can be found on the website on the Stability and Growth Pact maintained by the Directorate-General for Economic and Financial Affairs: http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm.

Box 4.1: Excessive deficit procedure

The excessive deficit procedure is specified in Article 104 of the Treaty, the associated Protocol on the excessive deficit procedure and Council Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure[34], which is the “dissuasive arm” of the Stability and Growth Pact. Together, they determine the steps to be followed to reach a Council decision on the existence of an excessive deficit, which forms the basis for the assessment of compliance with the convergence criterion on the government budgetary position.

Article 104(1) states that Member States are to avoid excessive government deficits. The Commission is required to monitor the development of the budgetary situation and of the stock of government debt in the Member States with a view to identifying gross errors (Article 104(2)). In particular, compliance with budgetary discipline is to be examined by the Commission on the basis of the following two criteria:

“*(a) whether the ratio of the planned or actual government deficit to gross domestic product exceeds a reference value* [specified in the Protocol as 3 percent]*, unless:*
— *either the ratio has declined substantially and continuously and reached a level that comes close to the reference value;*
— *or, alternatively, the excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value;*
(b) whether the ratio of government debt to gross domestic product exceeds a reference value [specified in the Protocol as 60 percent]*, unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace*”.

According to the Protocol on the excessive deficit procedure, the Commission provides the statistical data for the implementation of the procedure. As part of the application of this Protocol, Member States have to notify data on government deficits, government debt and nominal GDP and other associated variables twice a year, namely before 1 March and before 1 September[35]. After each reporting date, Eurostat examines whether the data are in conformity with ESA95[36] rules and related Eurostat decisions and, if they are, validates them.

The Commission is required to prepare a report if a Member State does not fulfil the requirements under one or both of the criteria given above (Article 104(3)). The report also has to take into account whether the government deficit exceeds government investment expenditure and all other relevant factors, including the medium-term economic and budgetary position of the Member State. The next step in the procedure is the formulation by the Economic and Financial Committee of an opinion on this report, which according to the Stability and Growth Pact must occur within two weeks of its adoption by the Commission (Article 104(4)). If it considers that an excessive deficit exists or may occur, the Commission addresses an opinion to the Council (Article 104(5)).

Then, on the basis of a Commission recommendation, the Council decides, after an overall assessment, including any observation that the concerned Member State may have, whether an excessive deficit exists (Article 104(6)). The Stability and Growth Pact prescribes that any such decision has to be adopted within three months of the reporting dates (1 March, 1 September). At the same time as deciding on the existence of an excessive deficit, the Council has to issue a

34 OJ L 209, 2.8.1997, p. 6.
35 Council Regulation (EC) No 3605/93 on the application of the Protocol on the excessive deficit procedure, OJ L 332, 31.12.1993, p. 7, as last amended by Commission Regulation (EC) No 351/2002, (OJ L 55, 26.2.2002, p. 23).
36 European System of National and Regional Accounts, adopted by Council Regulation (EC) No 2223/96 (OJ L 310, 30.11.1996, p. 1) as last amended by Regulation (EC) No 1267/2003 of the European Parliament and of the Council (OJ L 180, 18.7.2003, p. 1).

recommendation to the Member State concerned with a view to bringing that situation to an end within a given period, also on the basis of a Commission recommendation (Article 104(7)). The Council recommendations are in principle non-public but in recent years have as a rule been made public by the Council at the request of the concerned Member State. According to the Stability and Growth Pact, the recommendation under Article 104(7) has to specify when the correction of the excessive deficit should be completed, namely in the year following its identification (unless there are special circumstances), and has to include a deadline of four months at most for effective action to be taken by the Member State concerned.

Where it establishes that there has been no effective action in response to its recommendations, the Council may make its recommendations public on the basis of a Commission recommendation (Article 104(8)). According to the Stability and Growth Pact, a decision under Article 104(8), which is necessary to establish non-compliance by the Member State concerned with the recommendation addressed to it under Article 104(7), has to be taken immediately after the expiry of the deadline for effective action. The provisions of Article 104(9 and 11), on enhanced Council surveillance and ultimately sanctions in case of non-compliance, are not applicable to Member States with a derogation (that is, those that have not yet adopted the euro), which is the case of the Member States considered in this report.

When, in the view of the Council, the excessive deficit in the Member State concerned has been corrected, the Council abrogates its decision on the existence of an excessive deficit, again on the basis of a Commission recommendation (Article 104(12)).

4.2. Overview of recent budgetary developments

4.2.1. General government accounts

4.2.1.1. General government balance

Table 4.1
General government balance
(as percentage of GDP)

	1998	1999	2000	2001	2002	2003	2004(*)
CZ	-5.0	-3.6	-3.7	-5.9	-6.8	-12.6	-5.0
EE	-0.3	-3.7	-0.6	0.3	1.4	3.1	0.3
CY	-4.3	-4.5	-2.4	-2.4	-4.6	-6.4	-5.2
LV	-0.6	-4.9	-2.8	-2.1	-2.7	-1.5	-2.0
LT	-3.0	-5.6	-2.5	-2.0	-1.5	-1.9	-2.6
HU	:	:	-3.0	-4.4	-9.2	-6.2	-5.5
MT	:	:	-6.2	-6.4	-5.9	-9.7	-5.2
PL	-2.1	-1.4	-0.7	-3.8	-3.6	-3.9	-5.6
SI	:	:	-3.5	-2.8	-2.4	-2.0	-2.3
SK	-3.8	-7.1	-12.3	-6.0	-5.7	-3.7	-3.9
SE	1.8	2.5	5.1	2.8	0.0	0.3	0.6
EUR-12	-2.2	-1.3	0.1	-1.7	-2.4	-2.7	-2.9
EU-25	:	:	0.8	-1.2	-2.3	-2.8	-2.8

(*) Forecast

Source: Commission services

Budgetary positions differ widely across the Member States considered in this report. Table 4.1 presents the evolution of the general government balance during the period 1998-2003, including Commission services forecasts for 2004. For ease of comparison, the aggregates for the EU as a whole and for the euro area are also shown. It has to be noted that pre-2000 data for the new Member States are of uneven quality[37] and in some cases are missing altogether.

In 2003, the last year for which actual data are available and therefore the main reference for this report, two Member States (Estonia and Sweden) had a surplus on the government accounts, three (Lithuania, Latvia and Slovenia) had government deficits equal to or slightly less than 2 percent of GDP, while the remaining six had deficits in excess of 3 percent of GDP. Of these, two (Slovakia and Poland) had deficits close to 4 percent of GDP, two others (Hungary and Cyprus) had deficits close to 6 percent of GDP and the remaining two (Malta and the Czech Republic) had deficits close to or in excess of 10 percent of GDP. It should be noted that the very high government deficits in the Czech Republic and in Malta reflected the impact of large one-off operations (respectively, the imputation of a state guarantee extended to a private bank and the assumption of liabilities of a restructured state-owned company): without these operations the deficits would have been around 6 percent and 6½ percent of GDP, respectively.

Looking at the evolution since 1998, only Sweden has consistently recorded a surplus or a balance on the

37 Eurostat has only validated data on the public finances of the new Member States for the period 2000-2003.

budget balance throughout the period, while Estonia has been posting surpluses since 2001. The new Member States other than Estonia have had budget deficits throughout the period considered. A gradual trend towards fiscal consolidation is visible in the three Member States currently with deficits of less than the 3 percent of GDP reference value (Latvia, Lithuania and Slovenia). In the remaining Member States (those with deficits in excess of the reference value) budgetary positions in general have exhibited more volatility and have not shown a trend toward improvement. However, progress with fiscal consolidation can be seen in Slovakia, particularly if the budgetary figures are netted out for the effect of one-off operations (see also below).

In 2004, government deficits are forecast by the Commission to decline in four of the six new Member States with deficits currently in excess of 3 percent of GDP (the Czech Republic, Malta, Cyprus, Hungary) and to increase in the remaining two (Slovakia, Poland). Adjusting for the expiration of the above-mentioned one-off deficit-increasing operations in Malta and the Czech Republic, the expected deficit reductions ranges between ¾ and 1 ¼ percent of GDP. By contrast, a significant deficit increase is expected in Poland mainly due to increases in expenditure. Deficits are also expected to increase in the new Member States with deficits below 3 percent of GDP. The deficit increase is particularly noticeable in Lithuania reflecting a large increase in expenditure, including expenditure related to EU-accession. A significant reduction in the surplus moving towards a close-to-balance position is expected in Estonia, reflecting the impact of tax cuts and increases in expenditure, including expenditure related to EU-accession. A surplus is expected in Sweden.

4.2.1.2. Influence of cyclical conditions and one-off operations

Changes over time in the general government balance reflect the impact not only of discretionary policy choices but also of fluctuations in economic activity. In particular, reflecting the features of the tax and spending system, various revenue and expenditure categories react automatically to cyclical swings (so-called automatic stabilisers). As a result, the budget balance tends to improve in years of high growth and to deteriorate in economic slowdowns. Cyclically-adjusted budget balances are calculated to correct the budget balance for the influence of the cycle and therefore capture the underlying trend in the budget balance, which reflects more closely the evolution of the policy stance. However, for the new Member States, a satisfactory information base to calculate such cyclically-adjusted balances is at this stage not yet available. Nonetheless, it is probably safe to say that relatively large variations in budgetary outcomes in the new Member States reflect a correspondingly high volatility of output and frequency of policy changes. Another factor that has to be taken into account is the impact of temporary factors unrelated to the cycle, which, as mentioned above, distort annual comparisons of budget outcomes. In some of the new Member States, such one-off operations, often linked to the reduction of the presence of the government in the economy, have significantly affected budgetary outcomes.

As an illustration of the influence of *cyclical conditions* as opposed to fiscal policy measures on budget outcomes, Graph 4.1 depicts economic growth rates and deficit ratios over the period 1998-2004 for each of the eleven Member States. For ease of comparison, the average growth rate for the period 1995-2004 in each Member State is also indicated.

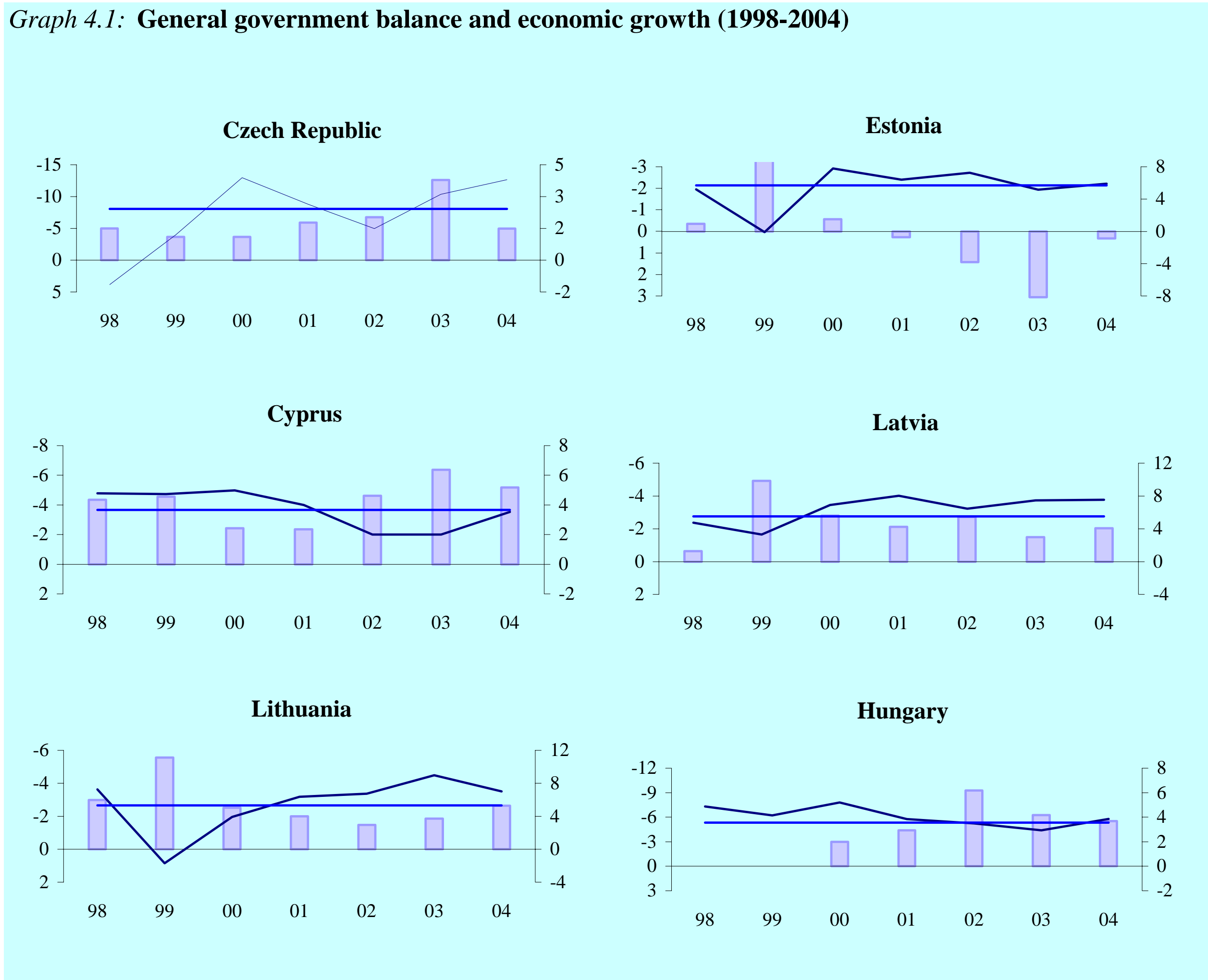
As regards the countries not currently in excessive deficit, the following conclusions can be drawn. In Estonia, Latvia and Lithuania, cyclical conditions were generally supportive of consolidation since 2000 (after weak or negative growth in 1999 in the aftermath of the Russian crisis). However, despite some consolidation efforts, the beneficial impact on the budgetary position over the period was less than might have been expected, due to the implementation of direct tax relief that was not fully compensated by expenditure reductions. In Slovenia, there was a moderate improvement in the budgetary position since 2000 in an environment of relatively low growth; the delay in the expected recovery in 2002-2003 has hampered a further improvement in spite of supplementary budgets, given structural inflexibility on the expenditure side owing to

the high share of mandatory spending. In Sweden, an expansionary fiscal stance, including the implementation of income tax cuts in 2000-2002, and relatively weak growth since 2001 contributed to a sharp drop in the government surplus (after its 2000 peak of around 5 percent of GDP) and this effect was magnified by the implementation of income tax cuts, implying a drop by more than 2 percentage points of GDP in the cyclically-adjusted surplus over the period 2000-2003.

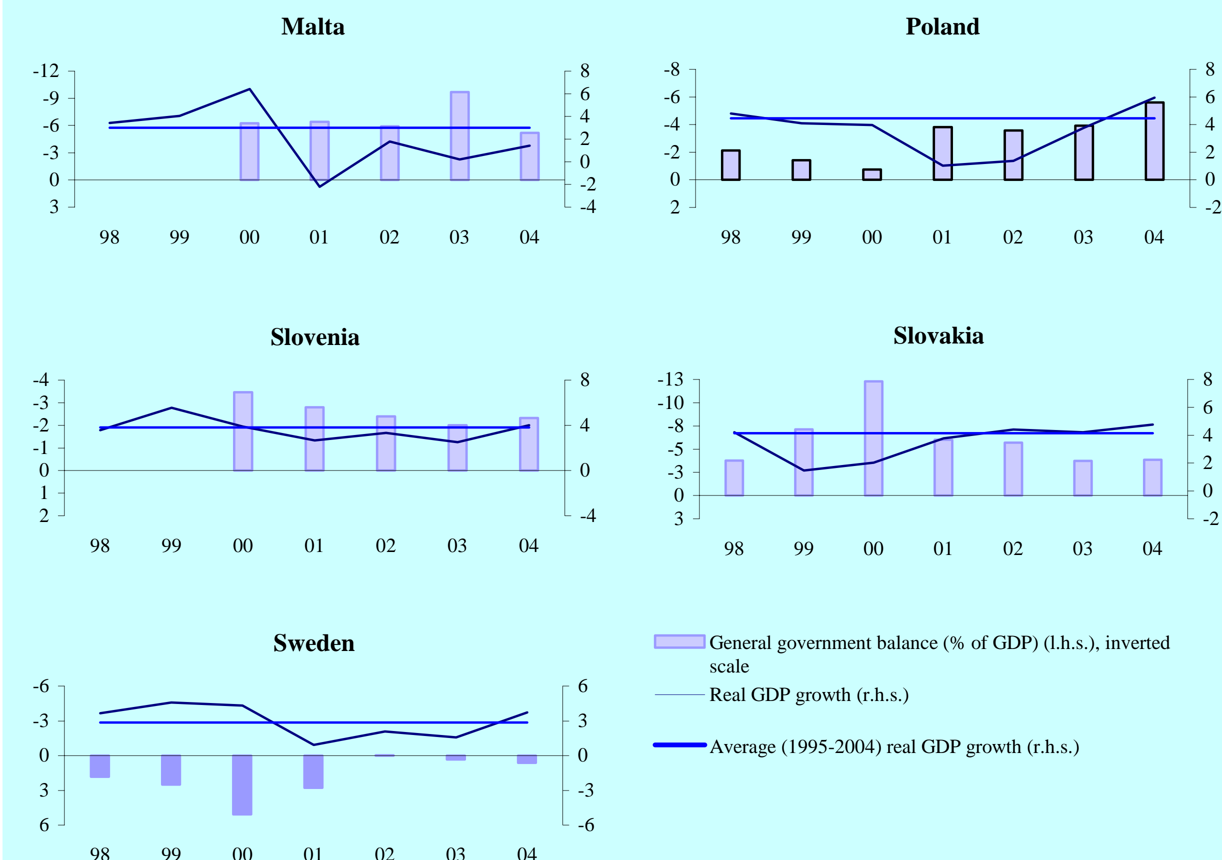
Turning to the countries found to be in excessive deficit, robust growth has prevailed from 2000 in the Czech Republic and 2001 in Slovakia. Disregarding the influence of some important one-off operations (see below), these favourable growth conditions did not translate into a sizeable improvement in the budget position given pre-election spending pressures and the weight of overruns in mandatory spending; in 2003, budgetary execution in both countries was more rigorous. In the remaining four countries (Cyprus, Hungary, Malta and Poland), there was a slowing of growth over the period 2001-2003, the budgetary impact of which was aggravated by a loosening of fiscal policy in all cases except Malta. In particular, Cyprus implemented a staged tax reform, the net budgetary impact of which was negative in view of compensatory measures, and raised public spending to counter the slowdown. In Hungary, where the slowdown was relatively modest, there was an increase in the public sector wage bill and social transfers as a share of GDP. Poland implemented corporate tax relief as well as increases in social spending and the relaxation of fiscal policy continued in 2003 despite the strengthening of growth.

In conclusion, whether cyclical conditions were conducive to an improvement in the government accounts or not, the stance of fiscal policy in recent years was not geared towards fiscal consolidation in most of the Member States under consideration. In other words, in countries marked by a favourable growth environment, the ensuing improvement of the public finance position was limited, while countries with disappointing growth have generally not counteracted the automatic deterioration in the budget position with a restrictive stance of fiscal policy.

Graph 4.1: **General government balance and economic growth (1998-2004)**



Graph 4.1: **General government balance and economic growth (1998-2004)** (continued)



Source: Commission services

One-off operations do not seem to have impacted significantly on the budget balances in the Member States currently in surplus or with deficits of less than the reference value. In the case of Lithuania, however, it should be noted that the budget balance might be affected in the future by the payment of VAT refunds and the implementation of compensation measures for savers and real estate restitution obligations.

In the other Member States (those currently with deficits in excess of the reference value), the influence of one-off operations on the deficits has been particularly significant in the Czech Republic, Hungary, Slovakia and Malta. In the Czech Republic, besides the one-off imputation of State guarantees worth around 7 percent of GDP to the government balance in 2003, large one-off capital transfers have repeatedly occurred mainly reflecting the operations of the public agency for the restructuring of the banking sector. In particular, such operations resulted in an increase in the 2002 budget deficit of almost 3 percent of GDP. In Hungary, the 2002 accounts were significantly

Table 4.2
Main features of the government account, 2003

(as percentage of GDP)

	Primary balance	Total revenue	Total expenditure	Interest expenditure	Primary expenditure	GFCF	Tax burden (*)
CZ	-11.3	41.9	54.5	1.3	53.2	4.2	36.5
EE	3.3	38.9	35.8	0.3	35.6	3.4	33.4
CY	-2.9	39.7	46.1	3.5	42.6	3.4	33.9
LV	-0.7	34.5	36.0	0.8	35.2	1.5	:
LT	-0.6	32.3	34.1	1.3	32.9	3.0	28.6
HU	-2.1	43.6	49.8	4.2	45.7	3.4	39.2
MT	-5.9	40.2	49.9	3.8	46.1	5.2	34.2
PL	-0.8	43.7	47.6	3.1	44.5	3.4	35.9
SI	0.1	46.2	48.2	2.1	46.1	2.8	40.4
SK	-1.2	35.4	39.2	2.5	36.6	2.6	31.2
SE	2.3	58.4	58.1	1.9	56.1	3.1	51.4
EUR-12	0.7	46.3	49.0	3.5	45.5	2.6	42.4
EU-25	0.3	45.6	48.4	3.1	45.3	2.5	:

(*) The tax burden comprises taxes and social contributions.

Source : Commission services

affected by one-off deficit-increasing operations, notably debt assumptions. One-off operations in Slovakia, mainly related to bank restructuring and government guarantees, resulted in very large capital transfers, of around 6 and 8 percent of GDP, respectively, in 1999 and 2000. In Malta, the restructuring of the shipyard industry resulted in a one-off charge to the general government balance of 3.2 percent GDP in 2003.

4.2.1.3. Government investment expenditure and other components of the government accounts

When examining compliance with the government deficit and debt criteria, the Commission has, according to Article 104(3) of the Treaty, to "*take into account whether the government deficit exceeds government investment expenditure*". Therefore, although the Treaty does not elevate the relationship between investment and the government deficit to the rank of convergence criterion, it grants it a specific importance when assessing fiscal discipline. This reflects the recognition that government investment may have a favourable impact on the productive potential of economies and therefore indirectly contribute to fiscal sustainability in the long term.

The Protocol on the excessive deficit procedure specifies that investment means gross fixed capital formation (GFCF). Data on government investment in 2003 are reported in Table 4.2. Longer runs of data are available in the tables for each Member State in Section 4.4.

The eleven Member States considered in this report have registered relatively high levels of government investment. All, except Latvia, have government investment ratios above the EU average. For the new Member States, this reflects their catching-up process and the need to upgrade infrastructure. Nevertheless, in 2003, government investment did not exceed the government deficit in any of the Member States with deficits in excess of the Treaty reference level. The government investment ratio was higher than, or equal to, the deficit in Latvia,

Lithuania and Slovenia, which recorded deficits below 3 percent of GDP, and in Estonia and Sweden, which were in surplus.

Over the period 1998-2003, government investment was never greater than the deficit in Czech Republic and in Malta. Investment exceeded the government deficit in Latvia and Slovakia in 1998, in Hungary in 2000, in Cyprus in 2000 and 2001, in Poland from 1998 to 2000, and in Lithuania and Slovenia since 2001.

Other components of the government account – notably total revenue and expenditure, the tax burden and interest expenditure, shown in Table 4.2 – are also relevant when considering the financial sustainability of the government position. High levels of government expenditure and high tax burdens may reduce the efficiency of economies and hamper their ability to grow. Moreover, there is evidence that the effectiveness of budgetary consolidation efforts depends on the composition of the adjustment measures, with reductions in current expenditure giving more successful results than revenue increases or cuts in investment spending.

The new Member States, in general, have government expenditure ratios which are only slightly below the average of the euro area or of the EU as a whole[38], while total revenue and the tax burden are below the EU average. However, given that their expenditure on interest is relatively low as their debt ratios are – with the notable exceptions of Cyprus and Malta – in general below the EU average, their primary expenditure is in some cases above the average of the euro area and of the EU as a whole.

It should be noted that data on total government expenditure and total government revenue in some of the new Member States may be not yet fully in line with the ESA95 accounting rules and not comparable with other Member States. Data on specific categories of revenue and expenditure, and on total expenditure and revenue, are considerably more sensitive to some difficulties in the compilation of data – for example because of issues of consolidation within the government units and of netting among transactions – than those for the balances. Moreover, data for 2003 are not directly comparable between the new Member States and EU-15 Member States, as accession to the EU implies that some expenditure and revenue are transferred from national authorities to the EU institutions[39].

4.2.2. Government gross debt

General government gross debt ratios for the period 1998-2003 and Commission services forecasts for 2004 are shown in Table 4.3. The table also reports, for comparison, the average government debt ratios in the EU and in the euro area. At the end of 2003, the debt ratio was below the reference value of 60 percent of GDP in nine of the eleven Member States considered (the Czech Republic, Estonia, Latvia, Lithuania, Hungary, Poland, Slovenia, Slovakia and Sweden), although at different levels and with different trends[40].

In Estonia, the debt ratio at the end of 2003 was very low at 5.3 percent of GDP; it has been relatively stable, hovering around that level over the latest years, and is even expected to fall slightly in 2004. The debt ratio was also low and relatively stable in Latvia (14.4 percent of GDP), Lithuania (21.4 percent) and Slovenia (29.4 percent). Small increases in the ratios are expected in 2004 for Latvia and Slovenia, while in Lithuania the debt ratio is expected to stabilise.

The government debt was also well below the reference value in the Czech Republic (37.8 percent of GDP), Poland (45.4 percent), Slovakia (42.6 percent) and Sweden (52.0 percent). However, while the debt ratio has

38 Total government expenditure for 2003 in the Czech Republic is exceptionally high because of an one-off imputation of State guarantees. For other years, total expenditure is below the EU average.

39 According to the accounting rules in force, expenditure by the EU institutions in the territory of a Member State – for example agricultural subsidies – and revenue earmarked for the EU budget – for example a share of VAT receipts – are not considered in government accounts and are not included in total government expenditure and revenue shown in the table.

40 The caveat on the quality of statistical data in Section 4.2.1 above also applies to the government debt. Moreover, given the relative size of deficit and debt levels in most Member States, debt ratios are considerably more sensitive to revisions in GDP levels than deficit ratios.

Table 4.3
General government gross debt

(as percentage of GDP)

	1998	1999	2000	2001	2002	2003	2004(*)
CZ	15.0	16.0	18.2	25.3	28.8	37.8	37.9
EE	5.6	6.0	4.7	4.4	5.3	5.3	4.8
CY	61.6	62.0	61.6	64.3	67.4	70.9	72.6
LV	9.8	12.6	12.9	14.9	14.1	14.4	14.7
LT	16.8	23.0	23.8	22.9	22.4	21.4	21.4
HU	61.6	60.9	55.4	53.5	57.2	59.1	59.9
MT	53.1	56.8	56.4	62.2	62.7	71.1	73.8
PL	n.a.	40.1	36.8	36.7	41.1	45.4	47.2
SI	23.6	24.9	27.4	28.1	29.5	29.4	30.8
SK	34.0	47.2	49.9	48.7	43.3	42.6	44.5
SE	68.1	62.8	52.8	54.4	52.6	52.0	51.6
EUR-12	74.1	72.8	70.4	69.5	69.4	70.7	71.2
EU-25	n.a.	n.a.	62.9	62.1	61.6	63.3	62.7

(*) Forecast

Source: Commission services

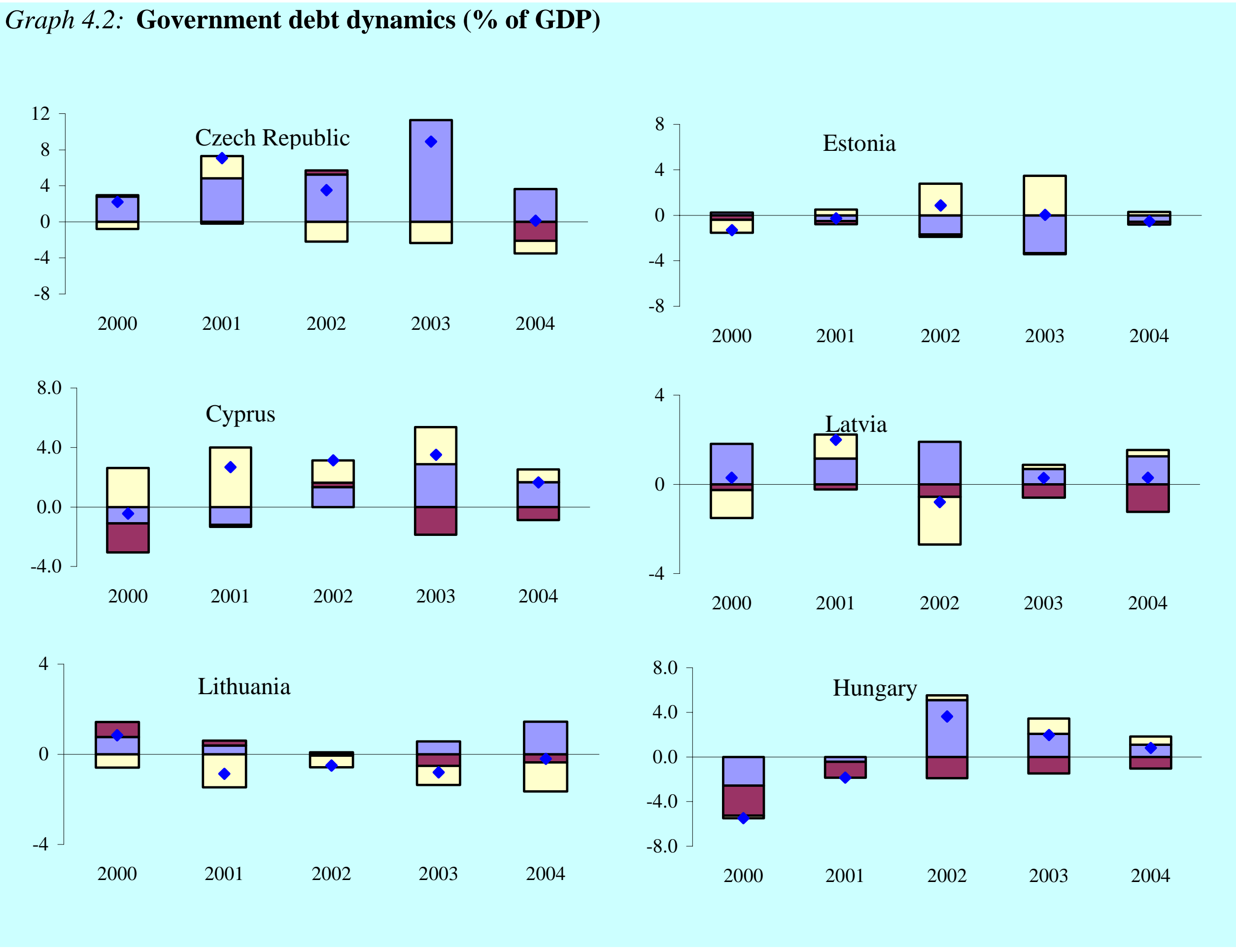
declined in Slovakia and Sweden, it has increased significantly in each of the other two Member States, and should rise further in 2004. Specifically, from 2000 to the current year, the government debt ratio is estimated to increase by almost 20 percentage points of GDP in the Czech Republic and by more than 10 points in Poland.

In Hungary, the government debt at the end of 2003 (59.1 percent of GDP) was only marginally below the Treaty reference value, while it was slightly above 60 percent of GDP at the end of the 1990s. The Hungarian government debt ratio is projected to increase to virtually 60 percent of GDP in 2004.

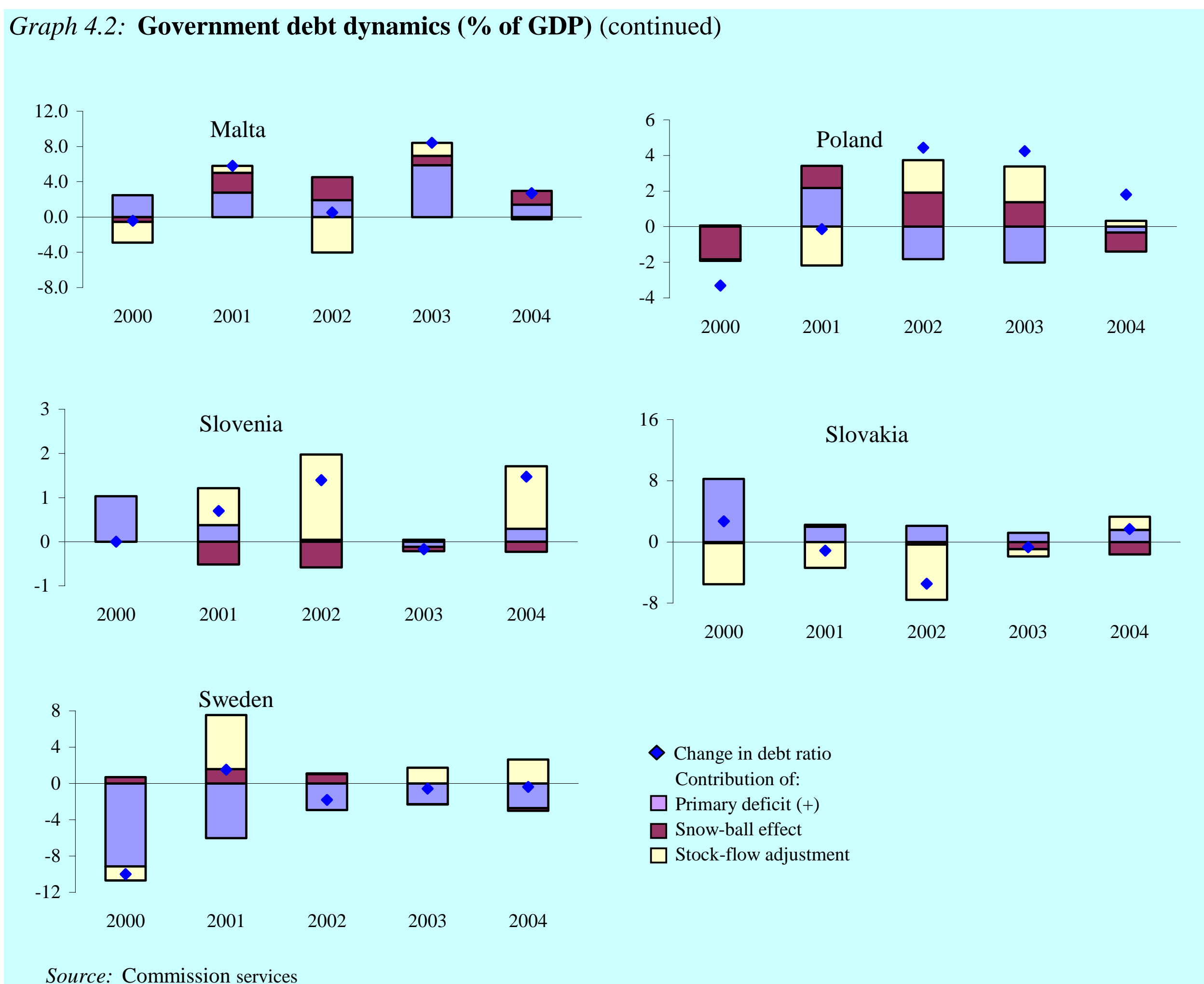
The government debt ratios of Cyprus (70.9 percent of GDP at the end of 2003) and Malta (70.4 percent) are above the reference value and the ratio has increased very quickly in recent years, given their large primary deficits and, in the case of Cyprus, large positive stock-flow adjustments[41]. During the three years to end-2003, the debt ratio increased by 9¼ percentage points in Cyprus and by almost 15 points in Malta. The debt ratio is projected to further increase in 2004 in both countries.

41 The stock-flow adjustment ensures the consistency between the deficit and the variation in the outstanding stock of debt. It includes the difference between accrual and cash accounting, the accumulation of financial assets, the changes in the value of debt denominated in foreign currency and other statistical adjustments. A positive stock-flow adjustment means that factors other than the government deficit increase the government debt level, while a negative stock-flow adjustment contributes to reducing the debt.

Graph 4.2: **Government debt dynamics (% of GDP)**



Graph 4.2: **Government debt dynamics (% of GDP)** (continued)



Source: Commission services

Graph 4.2 breaks down the yearly change in the debt ratio in three components: the primary balance, the combined impact of GDP growth and interest expenditure, which is often known as the snow-ball effect or debt-inertia effect, and the stock-flow adjustment[42].

42 The debt dynamics (or the budgetary constraint) for a country can be expressed by the following equation: $D_t = D_{t-1} + NB_t + SF_t$, where t denotes a time subscript, D the government debt level, NB the government deficit (net borrowing) and SF the stock-flow adjustment. With the debt-to-GDP ratio on the left-hand side the equation becomes: $\frac{D_t}{Y_t} = \frac{D_{t-1}}{Y_{t-1}} \cdot \frac{1}{1+y_t} + \frac{NB_t}{Y_t} + \frac{SF_t}{Y_t}$, whereby Y represents GDP at current market prices and y the nominal GDP growth rate. The equation can now be written as $\frac{D_t}{Y_t} - \frac{D_{t-1}}{Y_{t-1}} = \frac{NB_t}{Y_t} - \frac{D_{t-1}}{Y_{t-1}} \cdot \frac{y_t}{1+y_t} + \frac{SF_t}{Y_t}$, showing the change in the gross debt ratio as the sum of the deficit ratio, the contribution of nominal GDP growth and the stock-flow adjustment. The equations for the debt level and debt ratio can also be presented emphasising

The primary deficit has been the main driver of the increase in the debt ratio in most countries. The snow-ball effect has been relatively small in many countries as the high nominal growth rates registered have offset the impact of the interest expenditure. In some cases (for example Latvia, Hungary and Slovenia), GDP growth has even been above the implicit interest rate on the government debt, thus resulting in a debt-decreasing snow-ball effect. In the most recent years, the stock-flow adjustment has led to a significant increase in the debt ratio in Cyprus (2000 to 2003), given the accumulation of financial assets, and in Poland (1999, 2002 and 2003) and Slovenia (2001 to 2002), because of the effect on the foreign currency-denominated debt of the depreciation of their national currencies. However, the stock-flow adjustment has contributed considerably to reducing the debt or to slowing down the debt increase in the Czech Republic (2002 and 2003), Lithuania (2000 to 2003) and Slovakia (2000 to 2002) because of their privatisation programmes. The stock-flow adjustment has been consistently positive, that is, debt-increasing, in Estonia and Sweden, as the surpluses recorded by their respective governments were invested in financial assets, rather than allocated to debt repayment.

4.3. Medium-term prospects

4.3.1. Convergence programmes

The Stability and Growth Pact requires each Member State to regularly submit information for the purpose of multilateral surveillance in the form of medium-term programmes and their annual updates[43]. These programmes, which for Member States that are not yet participating in the single currency are called convergence programmes, contain the government plans towards achieving the medium-term objective of a budgetary position of close-to-balance or in surplus and the assumptions regarding the development of the key economic variables. Based on assessments by the Commission and the Economic and Financial Committee, the Council is called to examine each programme and in particular to assess whether they provide margins for ensuring the avoidance of excessive deficits. A similar assessment has been undertaken by the Council for the subsequent annual updates of the programmes.

Sweden presented the most recent update of its convergence programme, covering the period 2003-2006, in early December 2003 and the Council examined it in January 2004[44]. The ten new Member States submitted their first convergence programmes covering the period 2004-2007 (2004-2008 for Estonia and Hungary) in May 2004, that is, immediately after their accession. The purpose of this early submission was to put the Council in the position of delivering its opinions on the new Member States' budgetary strategies at the same time as it issued the recommendations for the correction of the excessive deficits for those found to be in such a situation. The examination of the programmes, together with the issuing of the excessive deficit recommendations, was completed by the Council as planned by early July 2004.

4.3.2. Convergence programme projections for the general government balance

Table 4.4 presents the objectives for the government budget balance projected in the convergence programmes.

the role of the primary deficit (PD), *i.e.* the general government deficit excluding interest expenditure (I):

$$D_t = D_{t-1} \cdot (1 + i_t) + PD_t + SF_t \Leftrightarrow$$

$$\frac{D_t}{Y_t} = \frac{D_{t-1}}{Y_{t-1}} \cdot \frac{1+i_t}{1+y_t} + \frac{PD_t}{Y_t} + \frac{SF_t}{Y_t}$$, where $i_t = \frac{I_t}{D_{t-1}}$ denotes the implicit interest rate on the government debt. The equation can again be rearranged to show the change in the government debt ratio:

$$\frac{D_t}{Y_t} - \frac{D_{t-1}}{Y_{t-1}} = \frac{PD_t}{Y_t} + \frac{D_{t-1}}{Y_{t-1}} \cdot \frac{1+i_t}{1+y_t} + \frac{SF_t}{Y_t}$$, *viz.* as the sum of the primary deficit ratio, the snow-ball effect (*i.e.* the combined contribution of interest and nominal growth) and the stock-flow adjustment, which is the breakdown shown in Graph 4.2. The latter equation is also valid if y and i are expressed in real terms.

43 Council Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies (OJ L 209, 2.8.1997, p. 1), which is part of the Stability and Growth Pact.

44 The programmes submitted by the Member States, as well as the Commission's assessments and the Council's opinions can be found at: http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm.

Table 4.4
Convergence programme projections for the general government balance
(as percentage of GDP)

	2003	2004	2005	2006	2007	2008
CZ	-12.9	-5.3	-4.7	-3.8	-3.3	:
EE	2.6	0.7	0.0	0.0	0.0	0.0
CY	-6.3	-5.2	-2.9	-2.2	-1.6	:
LV	-1.8	-2.1	-2.2	-2.0	-2.0	:
LT	-1.7	-2.7	-2.5	-1.7	-1.5	:
HU	-5.9	-4.6	-4.1	-3.6	-3.1	-2.7
MT	-9.7	-5.2	-3.7	-2.3	-1.4	:
PL	-4.1	-5.7	-4.2	-3.3	-1.5	:
SI	-1.8	-1.9	-1.8	-1.5	-0.9	:
SK	-3.6	-4.0	-3.9	-3.9	-3.0	:
SE	0.2	0.4	1.2	1.6	:	:

Source: Convergence programmes (December 2003 for Sweden and May 2004 for the remaining countries)

In the new Member States the programmes generally project a significant consolidation of public finances to occur in the coming years on the back of the ongoing recovery and continuing buoyant growth.

The consolidation is more pronounced in the six new Member States currently in excessive deficit, particularly those with the highest initial deficits. By the year 2007 deficits of at most 3 percent of GDP are aimed for in all the new Member States with the exception of the Czech Republic and Hungary, where the reduction of the deficit below the reference value is foreseen for 2008[45]. The planned adjustments over the programmes' periods relative to the 2003 deficit levels are particularly large in the cases of the Czech Republic, Malta and Cyprus, although, as mentioned above, one-off deficit-increasing operations significantly distort the base-year deficit for the first two countries. Taking into account these one-offs and the fact that deficits are actually foreseen to increase in 2004 in some Member States, the largest deficit reductions are those planned in the programmes of Malta, Cyprus and Poland. The profile of the adjustment in Poland's programme, however, is markedly back-loaded, in contrast with the front-loaded adjustment in the programmes of Malta and Cyprus, the latter being the only Member State planning to complete the correction of the excessive deficit by 2005. A more gradual adjustment is planned in the programmes of Hungary, Slovakia and, taking account of the above-mentioned one-off effects, the Czech Republic.

A gradual improvement of the budgetary position from a deficit below the 3 percent of GDP reference value is also planned in the programmes of Slovenia and Lithuania, however in the latter only after an initial worsening projected in 2004 - partly in connection with EU accession - and in both cases without reaching a close-to-balance position within the programme period. The budget deficit in Latvia is planned to stay broadly unchanged at around 2 percent of GDP throughout the programme period, while in Estonia the programme plans a move from the surplus registered in 2003 to a balanced budget from 2004 onwards. In Sweden the programme projects gradually rising surpluses, in line with the national budgetary strategy of achieving a surplus of 2 percent of GDP on average over the cycle.

In its opinions on the programmes, the Council gave an assessment of the balance of risks attached to the achievement of the planned budgetary objectives.

45 The budgetary projections in the Czech convergence programme end in 2007 but the programme mentions that the proposed path of deficit reduction indicates that the elimination of the excessive deficit would be completed by 2008.

For the new Member States the balance of risks is assessed as broadly neutral in four cases – Estonia, Latvia, the Czech Republic and Slovakia. In the other cases the balance appears to be tilted to the downside. Negative risks include: a mixed record of fiscal consolidation or frequent expenditure overruns (in particular, Cyprus, Lithuania, Hungary and Slovenia); relatively optimistic macroeconomic assumptions (in particular, Lithuania, Hungary, Malta, Poland and Slovenia); uncertainty about the degree of implementation (in particular, Poland); and pending accounting issues.

Accounting issues, which concern in particular Sweden and Poland, but also some other new Member States, refer mainly to the impact on the government balance of a recent Eurostat decision on the classification of pension schemes. The decision clarifies that funded defined-contribution pension schemes cannot be treated in the national accounts as social security and therefore are classified outside the general government (see Box 4.2).

Box 4.2: Pension reforms, the classification of pension schemes and the government balance

Pension reforms

Most EU Member States, including those that are considered in this report, have reformed, are reforming or will reform, their pension systems to overcome the population ageing challenge and keep sustainable government finance. Pension reforms may encompass changes in the retirement age, the level of social contributions or adjustments in the parameters that determine the pension rights of each individual. The impact of these parametric reforms on the government balance at different horizons simply depends on whether the reform leads to higher or lower contributions and benefits between the government and the private sectors in each period.

Systemic reforms and the delimitation of general government

The impact on the government balance of systemic reforms – replacing or complementing pay-as-you-go systems with funded systems, and changing defined-benefit schemes (DB) to defined-contribution schemes (DC) – is more complex, as such reforms may lead to changes in the delimitation of general government, that is, on the units that are classified by statisticians as government and those that are classified elsewhere. If a pension scheme is classified in the government sector, contributions collected and benefits paid by the scheme are government revenue and expenditure and contribute to the government balance. If a pension scheme is classified as a private pension fund, its contributions and benefits contribute to the private sector balance.

The Eurostat decision of 2 March 2004

The accounting rules that are relevant for the compilation of the government deficit/surplus are established by the European System of National and Regional Accounts (ESA). However, some of the ESA rules are too generic and need to be interpreted and clarified to be applied to specific cases. Concerning the sectoral classification of pension schemes, ESA simply states that pension schemes classified in government are those which are "*imposed, controlled and financed by government*". On 2 March 2004, Eurostat clarified that funded DC pension schemes did not fulfil these criteria. Pensions paid by funded DC schemes depend primarily on financial markets performance and therefore are not controlled by government. Moreover, pensions paid by those schemes are financed by reserves that are not economically owned by government. Therefore, funded DC pension schemes cannot be classified in the government sector. The Eurostat decision on the classification of pension schemes is valid even if when DC schemes are mandatory, are managed by government (for example, managed by the same government agency in charge of the pay-as-you-go pillar) and there is some government guarantee of a minimum pension (*).

The Eurostat decision was based mainly on two considerations on who bears the risk of the pension scheme and who is the economic owner of the existing reserves. In the case of unfunded pension systems or of funded DB schemes, the government bears most economic risks, as the benefits to be paid are known beforehand or, at least, the award formulas are well defined in advance. The government is responsible for financing pension payments, irrespective of economic conditions, for example changes in the value of the existing reserves. In the case of funded DC schemes, the risk of positive and negative financial developments, in particular changes in the value and performance of the pension scheme's reserves, is borne by the scheme members (the pensioners and the future pensioners) and not by the government. Therefore, the reserves of funded DC schemes belong – from an economic

viewpoint, even if not from a legal perspective – to the scheme members. The contributions paid to the funded DC schemes are saving of the scheme members; the scheme members are lending a share of their saving to the pension schemes and will be reimbursed through the payment of pensions in future.

The classification of funded DC schemes in a sector other than general government implies that contributions collected and pensions paid by these schemes are not government revenue and expenditure, and do not contribute to the government balance. Therefore, when a government decides to create a new funded DC pension scheme and transfers to this new scheme a share of the social contributions that were previously collected by an unfunded pension scheme, the short-term government balance will probably worsen, as government revenue falls. However, the pensions that will be paid in future by the new pension scheme will not count as government expenditure – as they will be paid by a unit classified in the private sector. This means that such a reform will improve the government balance in the longer term at the cost of a deterioration in the short term.

Quantitative implications of the Eurostat decision

The Polish second pillar, which was created in the context of the 1999 social security reform**,** has been classified by the Polish statistical office in the government sector, but Eurostat has not yet confirmed whether this is correct, as the government is still amending some details of the pension system. In case a sectoral reclassification of the Polish second pillar is needed, the government deficit will have to be revised upwards by 1½ to 1¾ percent of GDP. Slovakia has recently adopted a pension reform which creates new pension schemes as from 2005. The reform might lead to an increase in the government deficit by up to 1 percent of GDP, unless the new scheme were classified in the government sector (the Slovak convergence programme, unlike that of Poland, also presents budgetary objectives including the estimated impact of the classification of the second-pillar schemes outside the government sector, which are those considered by the Council in assessing the programme). In the case of Sweden, a sectoral reclassification of their funded DC pensions schemes would imply a decline in their respective government surpluses by around 1 percent of GDP, while Denmark has already revised Downward its surplus by around 1 percent of GDP.

There are also funded DC schemes in other countries, such as Latvia, Lithuania and Hungary, which are already classified outside government. In Hungary, the effect on the government deficit of the classification of the new pension scheme is currently ¾ percent of GDP, but might increase in future years to close to 1 percent of GDP. The amounts involved seem to be very small (less than 0.1 percent of GDP) in the case of Latvia, but might increase to around ½ percent of GDP by the end of the decade. In the case of Lithuania, the amounts at stake are close to ¼ percent of GDP but are expected to increase to ¾ percent of GDP by 2008.

On 23 September 2004 (**), Eurostat acknowledged that *"some Member States might need a transitional period to implement the decision and to avoid disruptions in the conduct of their budgetary policies. This transitional period will expire with the notification of 2007"*. At the time this report is adopted, it is not yet clear which Member States will benefit from the transitional period granted by Eurostat.

(*) Eurostat News Release No 30/2004 of 2 March 2004.
(**) Eurostat News Release No 117/2004 of 23 September 2004.

As mentioned above, the Council recommendations for the correction of the excessive deficits in the six new Member States were issued at the same time as the opinions on the convergence programmes of all new Member States. These recommendations represent a critical endorsement of the medium-term adjustment strategies contained in the respective convergence programmes. Therefore Cyprus is recommended to complete the correction of the excessive deficit in 2005, Malta is given until 2006 to complete the correction, Poland and Slovakia until 2007 and the Czech Republic and Hungary until 2008. Cyprus and Malta are also

Table 4.5
Convergence programme projections for general government gross debt

(as percentage of GDP)

	2003	2004	2005	2006	2007	2008
CZ	37.6	38.4	39.7	41.0	41.7	:
EE	5.8	5.4	5.1	4.7	3.4	3.2
CY	72.6	75.2	74.8	71.5	68.4	:
LV	15.3	16.2	16.8	17.3	17.7	:
LT	21.5	22.4	22.2	21.4	21.0	:
HU	59.1	59.4	57.9	56.8	55.6	53.7
MT	72.0	72.1	72.4	70.5	70.4	:
PL	45.3	49.0	51.9	52.7	52.3	
SI	28.6	29.1	29.5	29.4	28.4	:
SK	42.8	45.1	46.4	46.1	45.5	:
SE	51.7	51.5	50.0	48.3	:	:

Source: Convergence programmes (December 2003 for Sweden and May 2004 for the remaining countries)

recommended to reverse the rising trends in the debt ratios in line with their respective programmes (see next subsection).

4.3.3. Convergence programme projections for the debt

The evolution of the government debt ratios projected in the convergence programmes broadly mirrors that of the deficits (Table 4.5). Reflecting also high rates of nominal GDP growth, debt ratios are projected to be on a declining path in most of the new Member States from 2006 and in 2007 to fall below or close to their 2003 levels in all of them except the Czech Republic, Latvia, Poland and Slovakia. Only in the first two, however, a relatively significant increase is projected in the debt ratio over the programme period, although to a level remaining below the 60 percent of GDP reference value, while Latvia would continue to rank as one of the lowest-debt countries.

The two Member States that registered government debts above 60 percent of GDP in 2003 – Cyprus and Malta – do not project to remedy this situation within the horizon of their convergence programmes. Their debt ratios – which are still increasing – are expected to start declining in 2005 or 2006, respectively. Though the debt criterion is fulfilled if the government debt ratio "is sufficiently diminishing and approaching the reference value at a satisfactory pace" (see Box 4.1), it is important to extend in time the budgetary projections of these two countries to test how long it may take them to reduce the debt ratio below the Treaty reference value. This can be done, on an illustrative basis, with the help of some simple assumptions.

Table 4.6
Convergence of debt ratios in Cyprus and Malta

	Debt in 2000 (% of GDP)	**Debt in 2003** (% of GDP)	**Debt in 2007** (% of GDP)*	**Change in debt ratio 2000-2007** (% points of GDP)	**Change in debt ratio 2003-2007** (% points of GDP)	**Number of years from 2003 to bring debt ratio below 60% of GDP****	**Year when debt falls below 60% of GDP****
CY	61.6	70.9	68.4	6.8	-2.5	9	2012
MT	56.4	71.1	70.4	14.0	-0.7	11	2014

* As projected in the convergence programmes submitted in May 2004.

** The calculations to project the debt ratios beyond 2007, the final year covered in the convergence programmes, assume that the programmes' targets are fully respected, that the primary surpluses are kept at the level of 2007 (2.0% of GDP for Cyprus and 2.2% for Malta), that the real GDP growth after 2007 corresponds to the long-term average 1995-2004 (3.7% for Cyprus and 2.9% for Malta), that the implicit interest rate on the government debt is 6%, that the inflation rate is 2% and that the stock-flow adjustment is zero.

Source: Commission services and convergence programmes

Assuming that Cyprus and Malta fulfil the targets in their convergence programmes until 2007 and that, afterwards, they keep primary surpluses at the level projected for 2007, their debt ratios will fall below 60 percent of GDP within nine to eleven years from 2003, that is by 2012 in the case of Cyprus and 2014 in the case of Malta. The other assumptions, specifically, on economic growth and the interest rate on the government debt are detailed in the note to Table 4.6. However, one should stress the mechanistic nature of these projections, and the very different outcomes that would result from relatively small deviations from the assumptions. For example, primary surpluses 1 percent of GDP smaller, and GDP growth rates ½ percent lower, than assumed would lead to debt ratios above 60 percent of GDP beyond 2020 in the case of Cyprus and 2030 in the case of Malta. The opposite effect would result from a lower than assumed real interest rate. It should also be noted that the debt projections of the scenario described in Table 4.6 were made setting stock-flow adjustments at zero. Experience in other Member States has shown that stock-flow adjustments are very often debt-increasing. While the average stock-flow adjustment since 2000 has been negative in Malta, it has been significantly positive in Cyprus (+2.6 percent of GDP per year on average since 2000). If the average stock-flow adjustment for Cyprus were kept at that level in future, the gross debt ratio would keep increasing, instead of stabilising or declining, even if all the other assumptions in Table 4.6 were respected.

4.4. Developments by Member State

The following subsections discuss, for each of the eleven Member States, the pace of budgetary consolidation in recent years and the outlook for 2004. They also summarise the main points of the Council's assessment of the medium-term budgetary prospects as depicted in the respective convergence programmes. The section on Sweden starts with a summary of the assessment in the 2002 Convergence Report.

4.4.1. Czech Republic

The general government deficit has been on an upward trend since the end of the 1990s reaching a peak of 12.6 percent of GDP in 2003. The steady widening of the deficit has reflected both expansionary fiscal policies, in particular, rapidly increasing social expenditure, and one-off charges linked to the restructuring of the economy, in particular the operation of the Czech Consolidation Agency (CKA), and the imputation of state guarantees[46].

[46] In accordance with ESA95 methodology, the Czech authorities imputed high-risk state guarantees provided by the government as

In the period 1995-2002, mandatory social expenditure (including pensions, sickness benefits and family allowances) grew twice as fast as total general government expenditure, resulting in both higher deficits and crowding out of other public expenditure. At the same time, the Czech state took over bad assets, mainly through the operations of the CKA, and extended guarantees to the private sector with corresponding negative effects on the public accounts. For instance, reflecting the operations of the CKA, the 2002 deficit of 3.9 percent of GDP notified in April 2003 was revised upwards in August to 6.7 percent of GDP.

The budget planning for the year 2003 took place after parliamentary elections in June 2002 and the transition to a new government. The 2003 pre-accession economic programme targeted the general government deficit to increase from 6.7 percent in 2002 to 7.6 percent of GDP in 2003. Due to a one-off imputation of state guarantees, the 2003 deficit reached 12.6 percent of GDP. However, without the imputed state guarantees, the deficit would have been less than 6 percent of GDP, lower than expected in the 2003 pre-accession programme, in spite of additional one-off spending related to the arbitration proceedings against the CME[47] and expenditure for repair works after the 2002 floods. Specifically, revenues of the state budget were 2 percent higher than expected in the budget presented in December 2002. To this result contributed in particular VAT receipts (3.6 percent higher than expected), and excise duties (8 percent higher than expected) related to high household consumption in the second half of the year. On the expenditure side, unemployment benefits and capital expenditure were substantially higher than planned, by 10.3 percent and 9.2 percent respectively, but overall, total expenditures were only 1.6 percent higher than foreseen in the budget.

The target for the general government deficit in 2004 is 5.3 percent of GDP, marginally lower than the 2003 outcome excluding imputed state guarantees. On the revenue side, higher VAT and excise duties are expected to more than compensate for the fall in the corporate income tax rate from 31 percent to 28 percent. The overall budgetary impact of these tax changes on the general government balance is projected to be 0.9 percent of GDP. The implementation of new VAT rates from 1 May 2004 resulted in a further increase of the average effective tax rate. Despite higher expected tax revenues, the overall revenue ratio in 2004 is expected to remain at the level of 2003 reflecting a decline in other revenues. On the expenditure side, additional measures were taken as of June 2004 to mitigate the social consequences of the higher indirect tax burden. They include permanent as well as one-off additional social spending for the retired and for families with children. After the government crisis in summer, the new Czech government decided to follow the original budgetary plans for 2004. The better-than-expected economic performance and the satisfactory execution of the 2004 budget in the first eight months indicate that the 2004 deficit target is likely to be met.

The Czech convergence programme, which covers the period 2004-2007, was examined by the Council on 5 July 2004[48]. The programme foresees the deficit to be reduced to 3.3 percent of GDP in 2007 and to fall further thereafter, with the following intermediate targets: 5.3 percent of GDP in 2004, 4.7 percent of GDP in 2005 and 3.8 percent of GDP in 2006. The adjustment path does not appear very ambitious, taking also into account the projected recovery in the economy and the absence of fundamental reforms in social expenditure. The macro-economic scenario underlying the programme reflects cautious growth assumptions. The risks to the budgetary projections appear broadly balanced. On the one hand, the cautious macroeconomic scenario suggests that revenues could be better than expected and that expenditures could be less than budgeted. On the other hand, there are risk linked to the implementation of tax reform, specifically, the impact of the numerous coinciding tax changes in 2004 on the behaviour of economic agents. In addition, important savings measures, particularly regarding government consumption, still need to be agreed upon. Overall, the budgetary stance in the programme should be

capital transfers into the general government deficit and debt figures since 1994.

47 In 1993, CME (Central-European Media Enterprises Group) bought the first Czech private TV broadcaster NOVA. CME sued the Czech Republic for not protecting its investment. In 2003, the Czech Republic lost the case before the arbitration court in Stockholm, forfeiting almost 0.5 percent of GDP.

48 See footnote 45.

Table 4.7
Czech Republic: budgetary developments

(as percentage of GDP unless indicated otherwise)

		1998	1999	2000	2001	2002	2003	2004(*)
General government balance		-5.0	-3.6	-3.7	-5.9	-6.8	-12.6	-5.0
- Total revenue		38.8	39.2	38.5	39.1	40.2	41.9	42.3
- Total expenditure		43.8	42.9	42.1	45.0	46.9	54.5	47.3
of which :	- Interest expenditure	1.2	1.0	0.9	1.1	1.5	1.3	1.3
	- Primary expenditure	42.6	41.9	41.3	43.9	45.4	53.2	46.0
	- GFCF	4.1	3.0	2.9	3.2	3.7	4.2	4.3
Primary balance		-3.8	-2.6	-2.8	-4.8	-5.2	-11.3	-3.6
pm Tax burden		34.0	34.8	34.5	34.6	35.5	36.5	36.6
Government debt		15.0	16.0	18.2	25.3	28.8	37.8	37.9
pm Real GDP growth (%)		-1.1	1.2	3.9	2.6	1.5	3.1	3.8
pm HICP inflation (%)		9.7	1.8	3.9	4.5	1.4	-0.1	2.8

(*) Forecast

Source: Commission services

sufficient to reduce the deficit to the 3 percent of GDP deficit threshold by 2008.

The debt-to-GDP ratio more than doubled between 1998 and 2003, when it reached 37.8 percent of GDP. The steep increase in the debt ratio since 2002 is due to a combination of high government deficits, the assumption of considerable contingent liabilities and a drop in privatisation proceeds. The debt ratio is projected to further increase by 3.9 percentage points over the convergence programme period, reaching 41.7 percent of GDP in 2007.

4.4.2. Estonia

Estonian fiscal policy has been relatively tight throughout the entire stabilisation and early transition period of the 1990s. The authorities have consistently kept public finances under control by targeting balanced budgets on an annual basis. Fiscal consolidation in the late 1990s was brought about by a falling expenditure-to-GDP ratio, while revenues, despite tax reductions, were sustained by generally strong economic growth. The exception was 1999, when real GDP declined as a consequence of the 1998 Russian crisis, and the general government deficit rose to a one-time high of 4 percent of GDP. It was rapidly brought down to 0.3 percent of GDP already in the following year and in 2001 a small surplus of 0.3 percent of GDP was reached. Since then, solid surpluses have marked the fiscal picture.

In 2003, general government posted a surprise surplus of 3.1 percent of GDP. This outcome compared favourably with a targeted surplus of 0.4 percent of GDP in the August 2003 pre-accession economic programme. The positive result was achieved not only through somewhat stronger-than-projected real GDP growth of 5.1 percent, but also through improved tax collection, despite additional election-induced spending in 2003, and considerable deficits of local government.

Estonia’s budgetary target for 2004, as outlined by the recent budget proposal for 2005, is for the general government account to remain in surplus of 0.3 percent of GDP. Moving from a comfortable surplus of 3.1 percent of GDP in 2003 to a much smaller one implies a considerable easing of fiscal policy. Yet, the country has a track record of fiscal prudence, as both GDP growth and budgetary results tended to exceed targets in recent years. Downside risks may derive mainly from cuts in direct taxes that may lead to an unexpectedly high revenue shortfall, or from adverse growth developments stemming from possible exogenous shocks. On the whole, the budgetary outcome for 2004 looks set to be broadly in line or even above the target because of likely higher-than-projected growth, and improving tax collection.

The Estonian convergence programme, which covers the period 2004-2008, was examined by the Council on 5 July 2004[49]. The programme's budgetary strategy aims at maintaining sound public finances defined as budgetary position of close-to-balance or in surplus. To this end, the programme targets a small surplus of 0.7 percent of GDP in 2004[50] and balanced budgets from 2005 onwards, accompanied by a gradual reduction in both the revenue and expenditure ratio, following a rise in both ratios in 2004 in connection with EU accession. In particular, the programme incorporates reforms resulting in reduced direct taxes, combined with increased transfer payments and tax allowances. Strong growth, improved tax collection, savings on the expenditure side and changes to the spending structure along with increased VAT and excise duty revenues are projected to finance these reforms.

The programme's macroeconomic scenario assumes that real GDP growth will accelerate from 4.7 percent in 2003[51] to 5.3 percent in 2004 and further to close to 6 percent p.a. over the rest of the programme period. The main sources of growth would be domestic demand expanding at around 7 percent p.a. and strengthening export growth of up to 10 percent annually. Private consumption is projected to grow at annual rates of between 5 and 6 percent. Investment is set to stay lively, expanding at between 7 and 9 percent per year, albeit no longer at rates above 10 percent as was the case in recent years. Consumer price inflation is set to increase to rates around 3 percent p.a. starting in 2004, after a record low of 1.3 percent in 2003.

The projections appear on the whole plausible. As far as GDP growth is concerned, they contain a certain margin of prudence, given that growth has been stronger than expected in the first half of 2004, at 6.3 percent year-on-year. Therefore there is a distinct possibility of stronger-than-projected growth for the whole year 2004. The external account deficit is set to decline from 13.7 percent of GDP in 2003 to around 8 percent of GDP by 2008. Nonetheless, the correction of the external balance will most certainly be delayed, and the deficit is expected to remain around a ratio of 13 percent of GDP also in 2004.

The risks to the budgetary projections appear broadly balanced. On the one hand, Estonia has established a track record of prudent forecasting and repeated overshooting of fiscal targets over the past few years. On the other hand, an unexpected revenue shortfall from the planned tax cuts, or an adverse impact on growth from exogenous shocks cannot be excluded altogether. Therefore the budgetary stance in the programme seems sufficient to maintain the Stability and Growth Pact's medium-term objective of a budgetary position of close-to-balance or in surplus; it should also provide a sufficient safety margin against breaching the 3 percent of GDP deficit threshold with normal macroeconomic fluctuations.

At less than 5 percent of GDP, Estonia's debt-to-GDP ratio is almost the lowest in the EU. The debt ratio is set to decline further. Because of its limited size, public debt - which is entirely covered by public sector reserves - is a negligible risk to the Estonian economy.

49 See footnote 45.
50 This target was in the meantime revised downward to a surplus of 0.3 percent of GDP in 2004, following the proposal of a supplementary budget to the tune of 0.4 percent of GDP to Parliament in September 2004.
51 Following a statistical methodology change, GDP levels were revised upward.

Table 4.8
Estonia: budgetary developments

(as percentage of GDP unless indicated otherwise)

		1998	1999	2000	2001	2002	2003	2004(*)
General government balance		-0.3	-3.7	-0.6	0.3	1.4	3.1	0.3
- Total revenue		38.9	38.8	37.7	37.2	38.0	38.9	37.6
- Total expenditure		39.3	42.6	38.2	36.9	36.6	35.8	37.3
of which :	- Interest expenditure	0.5	0.4	0.3	0.2	0.3	0.3	0.3
	- Primary expenditure	38.8	42.2	37.9	36.7	36.3	35.6	37.0
	- GFCF	4.7	4.2	3.9	4.1	4.7	3.4	4.4
Primary balance		0.1	-3.4	-0.2	0.5	1.7	3.3	0.6
pm Tax burden		34.8	34.4	32.4	31.6	32.4	33.4	32.3
Government debt		5.6	6.0	4.7	4.4	5.3	5.3	4.8
pm Real GDP growth (%)		5.2	-0.1	7.8	6.4	7.2	5.1	5.9
pm HICP inflation (%)		8.8	3.1	3.9	5.6	3.6	1.4	3.2

(*) Forecast

Source : Commission services

4.4.3. Cyprus

In the period 1998-2003, Cyprus showed a mixed record of fiscal consolidation, with the general government deficit of around 4.5 percent of GDP in both 1998 and 1999. Following the introduction of an adjustment plan in 1999, fiscal consolidation efforts managed to reduce the deficit to 2.4 percent of GDP in 2000 and 2001, but slippage occurred again in 2002 and 2003 and the deficit reached 6.3 percent in 2003.

Slippages were due to low growth linked to adverse external conditions (which affected notably tourism) but also to government expenditure overruns including both high defence outlays and discretionary measures aimed at offsetting the economic downturn. At the same time, a staged tax reform was implemented in mid-2002 aimed at lowering direct taxation and increasing indirect taxation. Indirect tax revenue did increase but the package was not implemented as originally planned, as concessions were made, mainly in the form of compensatory transfers, in order to secure broad political support for the reform.

For 2003, the original target for the general government deficit provided in the 2002 pre-accession economic programme was 1.9 percent of GDP, with an expected GDP growth rate of 4.6 percent. However, the same factors that had led to an increase in the general government deficit in 2002 (an adverse external environment resulting in lower GDP growth, increased government spending and revenue shortfalls) brought a widening of the deficit to 6.3 percent of GDP in 2003. Total tax receipts increased by 9 percent, with a 25 percent increase in indirect tax revenues (owing partly to a rise in the VAT rate from 13 percent to 15 percent in January 2003) more than offsetting an 8 percent decline in direct tax revenues. However, expenditure swelled more rapidly at 18 percent, due to a rapid rise in wage expenditure and the compensating social expenditure measures linked to the tax reform mentioned above. Taking into account these compensatory measures, the tax reform is estimated to have produced a negative net impact on the general government balance in 2003 of about 1.5 percent of GDP. Finally, capital expenditure jumped by 30 percent in nominal terms as part of a discretionary fiscal policy effort aimed at counteracting the economic slowdown.

For 2004, the general government deficit target is set at 5.2 percent of GDP. The outcome is likely to be broadly in line with the target, given that GDP growth so far appears to be in line with expectations and that the convergence programme introduces additional corrective budgetary measures. Revenues

should benefit from, *inter alia*, increases in fees for public services and measures to improve tax administration and tax compliance. On expenditure, a multi-year framework will gradually be implemented that includes measures to contain wages and increase civil service efficiency, and ceilings on, or reductions of, defence outlays, subsidies and other current transfers.

The Cypriot convergence programme, which covers the period 2004-2007, was examined by the Council on 5 July 2004[52]. The budgetary strategy underlying the programme aims at reducing the deficit from 6.3 percent of GDP in 2003 to 2.9 percent by 2005 and to 2.2 percent in 2006 and 1.6 percent by 2007. This is underpinned by a package of mostly structural measures to contain expenditure, which is where historically most of the slippage occurred, and both structural and one-off measures to increase revenue, to about an equal degree. The measures are mostly implemented from 2005 onward. The adjustment path reflects the government's commitment to improve public finances given their intention to adopt the euro by 2007; this is the main factor behind the strong frontloading of the fiscal adjustment in 2005. Given the mixed record on fiscal consolidation, the target for 2005 looks rather ambitious and therefore requires a strong commitment, including taking additional measures if necessary, for its implementation.

The macroeconomic scenario underlying the programme, which projects real GDP growth to increase from 3.5 percent in 2004 to 4.5 percent in 2007, seems to reflect plausible growth assumptions. Nevertheless, budgetary outcomes could be worse than projected, especially concerning the achievement of the objective for 2005, given the size of the adjustment and the fiscal consolidation record of Cyprus.

During 1998-2000 the debt ratio remained relatively stable at about 62 percent of GDP but then resumed an upward trend from 2001 onward, reaching 64.3 percent in 2001 and 70.9 percent in 2003. The increase in the debt ratio was driven by primary deficits, as well as sizeable stock-flow adjustments. For the period 2004-2007, the convergence programme projects the debt ratio to peak at 72.6 percent in 2004 and then to decline by almost 7 percentage points by 2007. The projected decline in the debt ratio is mainly driven by the increasingly positive primary balances and nominal GDP growth exceeding the average interest rate on government debt in 2005-2007. However, the evolution of the debt ratio may be less favourable than projected given the risks to the deficit outcomes mentioned above.

52 See footnote 45.

Table 4.9
Cyprus: budgetary developments

(as percentage of GDP unless indicated otherwise)

		1998	1999	2000	2001	2002	2003	2004(*)
General government balance		-4.3	-4.5	-2.4	-2.4	-4.6	-6.4	-5.2
- Total revenue		34.3	34.2	36.3	38.0	37.3	39.7	40.6
- Total expenditure		38.6	38.7	38.7	40.4	41.9	46.1	45.8
of which :	- Interest expenditure	3.2	3.2	3.5	3.6	3.3	3.5	3.5
	- Primary expenditure	35.4	35.5	35.2	36.8	38.7	42.6	42.3
	- GFCF	3.0	2.6	3.1	3.1	3.1	3.4	3.5
Primary balance		-1.1	-1.4	1.1	1.2	-1.3	-2.9	-1.7
pm Tax burden		29.1	29.5	31.4	32.7	32.5	33.9	:
Government debt		61.6	62.0	61.6	64.3	67.4	70.9	72.6
pm Real GDP growth (%)		4.8	4.7	5.0	4.0	2.0	2.0	3.5
pm HICP inflation (%)		2.3	1.1	4.9	2.0	2.8	4.0	2.4

(*) Forecast

Source : Commission services

4.4.4. Latvia

Between 1998 and 2003, the budgetary position of Latvia exhibited a high degree of variability, partly reflecting exceptional factors (notably the Russian crisis in 1998). The general government budget deficit increased sharply from 0.7 percent of GDP in 1998 to 5.3 percent of GDP in 1999. Fiscal consolidation efforts were considerable from 1999, but weakened again in the run-up to the October 2002 general election.

Fiscal consolidation efforts during the period 1998-2003 were of a rather ad-hoc nature and not firmly embedded in a medium-term fiscal framework. The government pursued a policy of corporate income tax reductions, which were only partly offset by increased non-tax revenues. Compensating measures on the expenditure side were limited and not of a structural nature. In 2002, the general government deficit increased to 2.7 percent of GDP, up from 1.6 percent in 2001, and significantly above the initial target of 1.4 percent of GDP set by the government. Higher expenditure in 2002 reflected supplementary spending of main ministries approved at the end of the year, as well as a higher-than-expected deficit of local government, the latter widened by significant wage increases.

In 2003, the general government deficit narrowed to 1.5 percent of GDP, about half the targeted deficit of 2.9 percent set in the 2002 pre-accession economic programme. The overachievement of the target was mainly due to better-than-expected tax and contribution revenues, reflecting improvements in tax collection as well as higher-than-expected growth, and occurred despite a reduction of the main social contribution rate from 35 percent to 33 percent. Expenditure control by the government was tight and total expenditure did not reach the initially allocated amount. The reduction in the general government deficit also owed to an improvement in the balances of local government and social security. This end-result was particularly positive in the light of the fiscal slippage of 2002. For 2004, the Latvian convergence programme targets a general government deficit of 2.1 percent of GDP[53]. In light of the actual 2003 outcome of a deficit of 1.5 percent, this target amounts to a moderate deterioration of the budgetary position stemming from a decrease in the revenue-to-GDP ratio not completely offset by a reduction in the expenditure-to-GDP ratio. The 2004 budget reflected most of the government's structural reform agenda for the current legislative period, both on the revenue and expenditure sides, most notably

53 The deficit figure for 2004 that was submitted by the authorities for the autumn fiscal notification is set to 1.9 percent of GDP.

strengthening tax collection efficiency, financing the ongoing public sector reform and meeting obligations of EU and NATO membership. The authorities also plan to increase expenditure on projects with recognized priorities of increasing competitiveness and supporting employment growth and development of human resources, and infrastructure with support from EU funds. On the revenue side, the budget incorporated the ongoing tax reform, including a reduction of the corporate income tax rate from 19 percent in 2003 to 15 percent. Revenues from customs duties are expected to decline, with a further cut in the overall tax burden to 29.5 percent of GDP, partly compensated by a higher GDP share of non-tax revenues mostly linked to receipts of EU funding. In August the Latvian Parliament approved amendments to the budget law to provide for additional expenditure in 2004 of nearly 65.8 million lats. Around one-third of the new expenditures goes to the agricultural sector and one-sixth to wage increases of teachers. While the budget target remains unchanged at 2 percent of GDP, and is likely to be met in the light of very strong growth and an emerging tax overshoot in the first half of 2004, the implicit decision not to use the additional revenues to lower the deficit goes against recommendations of the Council opinion on the Convergence Programme of Latvia to use any extra revenues to lower the deficit.

The Latvian convergence programme, which covers the period 2004-2007, was examined by the Council on 5 July 2004[54]. The programme envisages a slight increase of the general government budget deficit of 0.1 percentage point of GDP in 2005, followed by an improvement of 0.2 percentage points to 2.0 percent of GDP in 2006; the budget balance remains unchanged at 2.0 percent of GDP in 2007.

The lack of fiscal consolidation over these years is ascribed to the limited room for fiscal manoeuvre due to the cost of economic restructuring and partly EU-financed spending plans. Over the programme period, revenue and expenditure shares are projected to decrease by around 1 percentage point of GDP. On the revenue side this is partly explained by the ongoing tax reform; nonetheless, tax collection efficiency is assumed to strengthen over the programme period and significant EU funding should be received by the end of the period. Firm expenditure control is assumed to operate in parallel. The macroeconomic scenario provided in the programme envisages average GDP growth of 6.7 percent for the 2004-2005 period, with a slight easing to 6.5 percent in the two latter years of the programme. Domestic demand is foreseen to remain the main driver of growth, primarily led by high investment and private consumption growth. In addition to vulnerability to external demand shocks, risks to growth stem from structural constraints. Overall, the macroeconomic projections are plausible though leaning towards the optimistic side. The relatively modest programme targets should therefore be attainable, with the single most important threat being an unforeseen slowdown of growth.

The general government debt ratio increased steadily albeit modestly from 10.6 percent in 1998 to 14.9 percent in 2001, though was reduced to 14.4 percent in 2003. The main factor shaping debt dynamics was the primary deficit, significantly offset by rapid nominal GDP growth and, in 2002, the effect of currency appreciation. The convergence programme foresees the debt ratio increasing to 17.7 percent of GDP in 2007. The main driving force of the growing debt ratio is again the primary deficit; stock-flow adjustments are projected to be small. Through the programme period the contribution of interest outlays remains broadly at the 2003 level, while nominal GDP growth has a substantial ratio-reducing effect.

54 See footnote 45.

Table 4.10
Latvia: budgetary developments

(as percentage of GDP unless indicated otherwise)

		1998	1999	2000	2001	2002	2003	2004(*)
General government balance		-0.6	-4.9	-2.8	-2.1	-2.7	-1.5	-2.0
- Total revenue		40.6	37.4	35.1	34.4	33.1	34.5	33.5
- Total expenditure		41.3	42.3	37.9	36.5	35.8	36.0	35.5
of which :	- Interest expenditure	0.8	0.8	1.0	1.0	0.8	0.8	0.8
	- Primary expenditure	40.4	41.5	36.9	35.6	35.0	35.2	34.7
	- GFCF	1.4	1.5	1.4	1.1	1.3	1.5	2.0
Primary balance		0.2	-4.1	-1.8	-1.1	-1.9	-0.7	-1.3
pm Tax burden		:	:	:	:	:	:	:
Government debt		9.8	12.6	12.9	14.9	14.1	14.4	14.7
pm Real GDP growth (%)		4.7	3.3	6.9	8.0	6.4	7.5	7.5
pm HICP inflation (%)		4.3	2.1	2.6	2.5	2.0	2.9	6.8

(*) Forecast

Source: Commission services

4.4.5. Lithuania

In recent years, the budgetary position of Lithuania was marked by a significant decline in the general government deficit, from 5.7 percent of GDP in 1999 to 1.5 percent in 2002. The deficit increased to 1.9 percent in 2003.

Fiscal consolidation was primarily the result of a cut in expenditure from 42.9 percent of GDP in 1999 to 34.3 percent in 2002. The expenditure adjustment was concentrated on primary spending, particularly government consumption and social transfers. Lower interest expenditure, induced by a steady decline in interest rates, also contributed to the adjustment. General government revenues fell from 37.3 percent of GDP in 1999 to 32.8 percent in 2002. The decrease of the tax-revenue ratio was largely due to the introduction of a number of tax benefits and exemptions from corporate and personal income tax. A decline in dividend income, levies and interest earnings, related to the sale of government assets, was the major factor explaining a decrease in non-tax revenues over the same period.

In 2003, the general government deficit increased slightly to 1.9 percent of GDP on the back of very strong growth, undershooting the 2.4 percent of GDP target foreseen in the budget for 2003. Revenues were overshot thanks to a 0.5 percent of GDP higher surplus than planned by social security, higher-than-expected corporate and personal income tax revenues by 0.8 percent of GDP (partly due to better administration of personal income tax and the elimination of exemptions for reinvested profits) and a better-than-expected budgetary balance of local government. This was partly offset by higher-than-budgeted expenditure through the implementation of an additional budget in the second half of 2003. The main increases in current expenditure took the form of compensation for the loss of rouble savings (about 0.4 percent of GDP) and agricultural subsidies (about 0.2 percent of GDP).

The 2004 general government deficit target is 2.7 percent of GDP according to Lithuania’s convergence programme. The main factors contributing to the widening deficit are: (i) more capital expenditure (0.5 percentage points of GDP) led by new investment projects co-financed by the EU, (ii) higher public consumption (1 percentage point of GDP) driven by salary increases for public sector workers, (iii) increasing subsidies (0.7 percentage points of GDP) led by allocations to farmers and (iv) a rise in social welfare benefits due to higher pensions and child benefits. Furthermore, the transition costs of the pension reform are estimated to account for 0.3 percent of GDP, although the voluntary nature of participation in the recently established second pillar makes the estimation uncertain.

Finally, a substantial increase in other expenditures is foreseen because of Lithuania's contribution to the EU budget (0.7 percent of GDP). The revenue side is expected to be largely influenced by EU structural aid. In addition, increases in excise duties on tobacco and petrol should raise receipts by about 0.2 percent of GDP. Changes in VAT rates required by accession are estimated to generate revenues worth close to 0.2 percent of GDP, more than offset by an expected loss of 0.3 percent of GDP from the change to a new VAT collection procedure. An emerging tax overshoot in the first months of 2004 led the Parliament to approve a supplementary budget in June, while maintaining the deficit target at 2.7 percent of GDP. Additional primary expenditure accounts for about 0.3 percent of GDP, of which social security payments, compensation payment for lost savings and real estate restitutions represent the biggest share. This is expected to be partially offset by lower interest expenditure. Although risks of a worse-than-planned budgetary outcome from a deceleration of growth in the second half of the year cannot be excluded, the revenue dynamics seem to leave a sufficient margin to meet the target.

The Lithuanian convergence programme, which covers the period 2003-2007, was examined by the Council on 5 July 2004[55]. The general government deficit is expected to increase from 1.9 percent of GDP in 2003 to 2.7 percent in 2004, and to decrease gradually thereafter to 1.5 percent in 2007.

The programme envisages a rise of the GDP-share of both revenue and expenditure in 2007 relative to 2003. The increase in the revenue ratio, by 2 percentage points, is mostly due to a significant expansion in non-tax revenues. The expenditure ratio is foreseen to increase by 1.8 percentage points over the same period, mainly driven by higher primary expenditure. The medium-term macroeconomic scenario envisages GDP growth to remain robust over the programme horizon, particularly in 2004 and 2005, when it is projected at some 7 percent. Looking further ahead, growth is expected to slow down slightly to about 6.5 percent in 2006 and 2007, but stays above potential as estimated by the national authorities. Domestic demand is foreseen to continue as the main driver of growth, primarily led by high investment and private consumption growth. The risk of lower-than-expected growth over the programme horizon cannot be ruled out and appears the main threat to the achievement of the envisaged budgetary targets.

Following an initial deterioration of the general government debt ratio in the aftermath of the Russian crisis, from 16.8 percent in 1998 to 23.8 percent in 2000, the ratio declined steadily to 21.4 percent in 2003. The major factors contributing to the decrease were the fiscal consolidation initiated in 2000, the use of privatisation proceeds to repay debt and the positive effect of the currency appreciation. The convergence programme projects an increase of the debt ratio in 2004 by about 1 percentage point, but afterwards the debt ratio should stabilise at about 21 percent of GDP by 2007.

55 See footnote 45.

Table 4.11
Lithuania: budgetary developments

(as percentage of GDP unless indicated otherwise)

		1998	1999	2000	2001	2002	2003	2004(*)
General government balance		-3.0	-5.6	-2.5	-2.0	-1.5	-1.9	-2.6
- Total revenue		37.4	37.3	35.8	33.0	32.8	32.3	33.6
- Total expenditure		40.4	42.9	38.4	35.0	34.3	34.1	36.3
of which :	- Interest expenditure	1.1	1.5	1.7	1.6	1.4	1.3	1.2
	- Primary expenditure	39.2	41.4	36.6	33.4	32.9	32.9	35.1
	- GFCF	2.6	2.6	2.4	2.2	2.8	3.0	3.2
Primary balance		-1.9	-4.1	-0.8	-0.4	-0.1	-0.6	-1.4
pm Tax burden		32.3	32.4	30.5	29.1	28.7	28.6	28.3
Government debt		16.8	23.0	23.8	22.9	22.4	21.4	21.4
pm Real GDP growth (%)		7.3	-1.7	3.9	6.4	6.8	9.0	7.0
pm HICP inflation (%)		5.0	0.7	0.9	1.3	0.4	-1.1	1.0

(*) Forecast

Source: Commission services

4.4.6. Hungary

Since 1998, the general government deficit has shown large fluctuations, particularly in the last three years. After a process of continuous deficit reduction until 2000, ending with a level of 3.0 percent of GDP, the general government deficit started to increase again in 2001. In 2002, it peaked at 9.3 percent of GDP about 3 percent of GDP referred to statistical operations implying a one-off expenditure increase. After a deficit of 6.2 percent in 2003, the authorities targeted a general government deficit of 3.8 percent of GDP for 2004. This target was revised twice: first to 4.6 percent of GDP in January 2004 and later to 5.3 percent of GDP in September 2004.

The large deterioration in Hungarian government finances after 2000 can be explained by the slowdown in economic activity in the years 2001 to mid-2003 and by the implementation of an expansionary fiscal policy in 2001-2002. It should also be noted that these deficit figures include an increasing annual revenue loss due to the reform of the pension system in 1998, which established a second-pillar defined-contributions pension scheme (see Box 4.2). The Hungarian authorities estimated that this additional burden to the general government finances reached 0.7 percent of GDP in 2003.

In 2003, the general government deficit was reduced from 9.3 percent in 2002 to 6.2 percent of GDP. Despite the achieved deficit reduction, the original budgetary target of a deficit of 4.5 percent of GDP was exceeded by about 1½ percent of GDP. This can be attributed to an overrun in general government expenditures. The main reasons for this were: (i) higher-than-planned increases in social benefits, as higher-than-forecast real wage growth and inflation implied a retroactive correction of pensions and an unexpected contribution to the cost of child care; (ii) a large increase in subsidies, notably for housing[56] and prescribed medicines; and (iii) higher-than-forecast interest expenditure. Despite real GDP growth being lower than projected in the 2003 budget, developments in overall tax revenues turned out to be better than expected at 44.5 percent of GDP (instead of 43.2 percent of GDP). This was mostly due to the dynamism of VAT and excise duties (reflecting higher-than-forecast consumption growth) and higher revenues from the simplified corporate tax scheme, which more than compensated for

56 A significant tightening of the eligibility criteria of the previously very generous housing subsidy policy was decided in December 2003. This resulted from mid- to end-December 2003 in a very large number of applications for housing loans under the old rules. As the loan subsidies were claimed by households in 2004, the full restrictive fiscal effect of the eligibility tightening can only be expected from 2005 onwards.

the shortfall in personal income tax, corporate profit taxes and social contributions.

The 2004 budget included a real wage freeze in the public sector, which, together with the ongoing reduction of the number of public employees, should trigger a significant deceleration in the wage bill. On the revenue side, the 2004 budget incorporated a tax reform which came into effect at the beginning of 2004. This included a cut in direct tax rates, a broadening of the tax base as well as a rise in the lower VAT rates and was foreseen to lead to a stable tax burden. In January 2004, the original general government deficit target of 3.8 percent of GDP for 2004 was revised to 4.6 percent of GDP, since the outcome of the 2003 budget revealed that several of the expenditure and revenue items were underestimated. In September 2004 the target was revised for the second time upwards to 5.3 percent of GDP, since shortfalls on the revenue side (VAT and personal income taxes), and overspending on the expenditure side (mainly interest expenditure and social benefits) became visible. Apart from these two revisions the government also adopted a series of expenditure freezes amounting to 1.3 percent of GDP relative to the budget baseline.

The Hungarian convergence programme, which covers the period 2004-2008, was examined by the Council on 5 July 2004[57]. The macro-economic scenario underlying the programme foresees real GDP growth of about 3½ in 2004, followed by an acceleration of the growth rate of ½ a percentage point per year until 2008. The medium-term growth assumptions seem to be on the optimistic side. The envisaged budgetary adjustment in the programme is frontloaded with the deficit decreasing from 5.9 percent of GDP in 2003 to 4.6 percent of GDP in 2004, followed by a yearly adjustment of some ½ percentage point, with the aim of bringing the general government deficit below 3 percent by 2008.

The decline in the expenditure ratio, underpinned by structural reforms, would more than compensate for the decline in the revenue ratio, resulting from the planned reduction of the overall tax burden. The consolidation strategy in the convergence programme seems conducive to a better quality of public finances. However, several risks are attached to the budgetary targets in the programme: (1) the whole adjustment strategy depends crucially on the success of meeting the 2004 deficit target; (2) there are no clear indications about the ambitious expenditure-reducing measures; (3) the planned deficit would be reduced below the 3 percent of GDP only in 2008, and only by a small margin, which could be prevented by any unfavourable macroeconomic or budgetary development. As it was already officially indicated by the authorities, the 2004 target as set down in the May convergence programme (4.6 percent of GDP) will not be met. This makes all the more important to seize all opportunities to catch up and accelerate the fiscal adjustment.

Between 1998 and 2001, the debt ratio declined steadily from almost 62 percent of GDP to 53.5 percent of GDP, driven by sound budgetary policy and relatively robust GDP growth. In 2002, this trend was reversed. The debt ratio increased sharply in 2002 to over 57 percent of GDP, due to the very high fiscal deficit in that year, and to 59 percent of GDP in 2003, thus approaching the 60 percent of GDP reference value. Beside the high deficit level, the depreciation of the forint contributed to the increase in the debt in 2003, since around a quarter of the public debt is denominated in foreign currencies. According to the convergence programme, the debt ratio would decrease from close to 60 percent of GDP in 2004 to about 54 percent of GDP in 2008. However, the slower reduction of the interest rates than projected and the upwards revised deficit indicate a slower reduction of the debt than foreseen.

57 See footnote 45.

Table 4.12
Hungary: budgetary developments

(as percentage of GDP unless indicated otherwise)

		1998	1999	2000	2001	2002	2003	2004(*)
General government balance		:	:	-3.0	-4.4	-9.2	-6.2	-5.5
- Total revenue		:	:	44.6	44.3	43.4	43.6	41.3
- Total expenditure		:	:	47.6	48.7	52.6	49.8	46.8
of which :	- Interest expenditure	:	:	5.6	4.8	4.1	4.2	4.4
	- primary expenditure	:	:	42.1	43.9	48.5	45.7	42.4
	- GFCF	:	:	3.2	3.8	4.9	3.4	3.2
Primary balance		:	:	2.6	0.4	-5.1	-2.1	-1.1
pm Tax burden		:	:	39.6	39.3	38.9	39.2	38.6
Government debt		61.6	60.9	55.4	53.5	57.2	59.1	59.9
pm Real GDP growth (%)		4.9	4.2	5.2	3.8	3.5	2.9	3.9
pm HICP inflation (%)		14.2	10.0	10.0	9.1	5.2	4.7	6.9

(*) Forecast

Source: Commission services

4.4.7. Malta

Between 1998 and 2002, the budget deficit of Malta steadily declined from 10.8 percent of GDP to 5.9 percent. Then it jumped again to 9.7 percent of GDP in 2003, of which 3.2 percentage points correspond to a one-off operation related to the restructuring of the shipyard industry.

Cyclical factors can to a large extent explain the reduction in the deficit achieved in 1999 and 2000, while discretionary adjustments took place in 2001 and 2002, when GDP growth was not supportive of fiscal consolidation.

In 2003, even without the cost of the one-off operation, the general government deficit would still have widened to 6.5 percent of GDP. This outturn implies a substantial slippage compared with the target of 4.6 percent of GDP set in the pre-accession economic programme of 2002, which assumed a real GDP growth of 3.1 percent. While growth turned out to be much weaker (only 0.2 percent), much of the slippage is not of a cyclical nature but rather reflects higher-than-planned public expenditure.

The deficit target for 2004 in the convergence programme is 5.2 percent of GDP, lower than that set in the 2004 budget (5.7 percent) presented in November 2003. Such differences are explained by different growth assumptions: 2.8 percent in the budget compared to 1.1 percent in the convergence programme. The deficit target of 5.2 percent of GDP for 2004 seems feasible, but requires strong resolution to fully implement the measures envisaged in the convergence programme. Total revenues are expected to increase by 5.3 percentage points of GDP, to reach 45.3 percent of GDP. Half of this amount is due to inflows under the financial cooperation agreement between Malta and Italy and from EU funds. Other additional receipts would stem from stronger enforcement in tax collection. Total expenditures should reach 50.5 percent of GDP in 2004, compared with 52.4 percent in 2003. In particular, the increases in interest expenditure (by 0.2 percentage points of GDP), public consumption (0.4 percent) and public investment (0.1 percent) would be more than compensated by the fall in the GDP share of transfers, subsidies and other expenditures by a total of 2.6 percentage points of GDP.

The Maltese convergence programme, which covers the period 2004-2007, was examined by the Council on 5 July 2004[58]. The macroeconomic scenario underlying the programme seems to reflect plausible growth assumptions. However, it remains subject to a

58 See footnote 45.

Table 4.13
Malta: budgetary developments

(as percentage of GDP unless indicated otherwise)

		1998	1999	2000	2001	2002	2003	2004(*)
General government balance		:	:	-6.2	-6.4	-5.9	-9.7	-5.2
- Total revenue		:	:	35.6	37.5	40.0	40.2	46.7
- Total expenditure		:	:	41.9	43.9	45.8	49.9	51.9
of which :	- Interest expenditure	:	:	3.8	3.6	3.9	3.8	3.8
	- Primary expenditure	:	:	38.1	40.3	41.9	46.1	48.1
	- GFCF	:	:	4.0	3.6	4.5	5.2	5.8
Primary balance		:	:	-2.5	-2.8	-1.9	-5.9	-1.4
pm Tax burden		:	:	29.7	32.0	34.5	34.6	33.9
Government debt		53.1	56.8	56.4	62.2	62.7	71.1	73.8
pm Real GDP growth (%)		3.4	4.1	6.4	-2.2	1.8	0.2	1.4
pm HICP inflation (%)		3.7	2.3	3.0	2.5	2.6	1.9	3.1

(*) Forecast

Source : Commission services

considerable uncertainty, due the high exposure to external shocks of the Maltese economy and a possible overestimation of the nominal GDP level. The consolidation path, foreseeing a sharp reduction in the deficit, seems within reach, given the room for manoeuvre provided by the termination of some investment projects. Nevertheless, achieving the fiscal targets requires a strong commitment by the authorities, while the recent revision of the real GDP growth figure for 2003 could imply some downward risks. Therefore, the budgetary stance in the programme might not be sufficient to reduce the deficit below the 3 percent of GDP deficit threshold by 2006, as envisaged in the programme.

The debt ratio increased from 53.1 percent in 1998 to 62.7 percent in 2002. In 2003, mainly as a result of the restructuring of the shipyard sector, the debt ratio jumped to 71.1 percent of GDP, thus rising further above the 60 percent reference value. The convergence programme projects a quasi stabilisation of the debt ratio in 2004 and 2005, followed by decline in the debt ratio to 70.5 percent in 2006 and 70.4 percent in 2007. According to the Council Opinion, the evolution of the debt ratio could be less favourable than projected in the convergence programme, given the above mentioned risks to the deficit.

4.4.8. Poland

The general government deficit increased from 1.9 percent of GDP in 1999 to 3.6 percent in 2002. The deterioration in Poland’s budgetary position over this period reflects a combination of cyclical factors and some discretionary relaxation of fiscal policy stemming mainly from an increase in social spending. The high costs of three major reforms implemented at the beginning of 1999, namely in public administration, health care and social security, weighed heavily on the central government budget. On the revenue side, a drop in tax receipts resulted among other from changes in direct taxation and from an extensive use of tax exemptions and rebates.

Since 2001, there have been many attempts by the Polish authorities to tackle the increasing general government deficit but none of the reform plans was implemented and the deficit continued to widen. Budgetary targets were frequently revised and often missed.

The August 2002 pre-accession economic programme projected a deficit of 3.6 percent of GDP in 2003. The 2003 pre-accession economic programme contained an upward revision of the 2003 deficit to 4.1 percent of

GDP[59]. The overshoot in the general government deficit reflected lax implementation of the fiscal measures, but also a different growth composition from that forecast.

Because growth was more export-led than expected, hence having a lower tax-content, and in spite of various measures to improve the tax administration, revenues in 2003 were lower than initially foreseen. In addition, personal income tax revenues were overestimated reflecting optimistic wage and employment forecasts. Higher-than-planned expenditure resulted from additional outlays for various social allowances and foreign currency-denominated debt servicing.

The Polish authorities targeted a significant widening of the general government deficit from 3.9 percent of GDP in 2003 to 5.7 percent in 2004 mainly due to increased expenditure, despite a considerable strengthening of economic growth. An additional reduction of the corporate tax rate in 2004 to 19 percent was implemented, after a cut from 28 percent to 27 percent in 2003. By contrast, the alignment of the VAT regime to EU legislation has led to an increase of the tax rate on various products to 22 percent (e.g. construction materials) from May 2004. The deficit outcome for 2004 could, however, be somewhat better than the initial target of 5.7% because of recent signs of strong growth and buoyant corporate tax revenues.

Poland's convergence programme, which covers the period 2004-2007, was examined by the Council on 5 July 2004[60]. The programme foresees the deficit to be reduced to below the 3 percent of GDP reference value in 2007. The reduction of the deficit between 2004 and 2007 represents an ambitious 4.2 percent of GDP. The largest annual reduction is expected for 2007 (1.8 percentage points). The projections for 2005 and beyond are built upon the Hausner Plan, which aims at structural reforms on the expenditure and revenue sides. The macroeconomic scenario underlying the programme seems to reflect rather favourable growth assumptions. If the growth forecast of 5.0 percent for 2004 and 2005 appears plausible, the evolution of growth in the medium-term, *i.e.* an increase in the GDP growth rate to 5.6 percent in 2006 and 2007, seems to be on the high side.

Several risks surround the programme targets. Besides downside macroeconomic risks, there is uncertainty over the implementation of the measures, with the planned adjustment being heavily back-loaded (the measures adopted or discussed in parliament by the end of September 2004 are estimated at 25-30 percent of planned savings). Finally, the planned figures for the deficit may have to be revised upwards by 1.6 percent of GDP, if it is established that the funded defined-contribution pensions scheme should be classified outside government (see Box 4.2 above). Therefore, the budgetary stance in the programme may not be sufficient to reduce the deficit to below 3 percent of GDP in 2007.

The deterioration of the fiscal accounts together with the slowdown in the privatisation process resulted in a sharp increase in the government debt ratio in the last two years. The debt ratio increased from 36.7 percent of GDP in 2001 to 45.4 percent in 2003. In the convergence programme, the debt ratio is projected to increase by a cumulative 7.4 percentage points over the period 2004-2006 to reach 52.7 percent of GDP at the end of 2006, before declining by 0.4 percentage points in 2007. The evolution of the debt ratio could be less favourable than projected given the risks to the deficit outcomes and to the realisation of planned privatisations. The classification of the funded pension scheme outside general government would lead to an increase in the debt ratio by approximately 4.5 percentage points. Even under this scenario, the debt ratio would remain below the 60 percent of GDP reference value over the programme period if the deficit targets were met.

59 This figure was revised downward in the fiscal notification (September 2004) to 3.9 percent of GDP.
60 See footnote 45.

Table 4.14
Poland: budgetary developments

(as percentage of GDP unless indicated otherwise)

		1998	1999	2000	2001	2002	2003	2004(*)
General government balance		-2.1	-1.4	-0.7	-3.8	-3.6	-3.9	-5.6
- Total revenue		44.5	44.9	42.5	43.8	43.9	43.7	40.4
- Total expenditure		46.6	47.0	44.2	47.7	48.1	47.6	46.0
of which :	- Interest expenditure	1.9	2.0	2.1	3.0	2.9	3.1	3.1
	- Primary expenditure	44.7	45.1	42.1	44.7	45.2	44.5	43.0
	- GFCF	3.9	3.6	2.5	3.5	3.6	3.4	3.5
Primary balance		-0.2	0.6	1.4	-0.8	-0.7	-0.8	-2.5
pm Tax burden		37.7	38.3	36.2	36.6	36.1	35.9	:
Government debt		n.a.	40.1	36.8	36.7	41.1	45.4	47.2
pm Real GDP growth (%)		4.8	4.1	4.0	1.0	1.4	3.8	5.9
pm HICP inflation (%)		11.8	7.2	10.1	5.3	1.9	0.7	3.5

(*) Forecast

Source: Commission services

4.4.9. Slovenia

In the period 1998-2003, general government deficits were relatively small, averaging 2.5 percent of GDP. After having increased to 3.5 percent of GDP in 2000, the deficit gradually returned to levels of slightly above 2 percent of GDP.

The government has committed itself to fiscal prudence and strives to improve the budgetary position. In December 2001, Slovenia started adopting budgets for two consecutive years with an aim to bring greater certainty in the long-term planning of public finance. In 2002-2003, however, general government expenditure overruns coupled with tax revenue shortfalls led to failures in achieving the initial deficit targets, thus prompting the adoption of supplementary budgets. These slippages were the result of overly optimistic domestic growth assumptions based on then common expectations of a recovery of the international economy, which failed to materialise. On the other hand, timely adjustments have been heavily strained by the structural rigidity as mandatory outlays account for more than four fifths of the budget.

At 2.0 percent of GDP in 2003, the general government deficit was much higher than 1.3 percent of GDP, the initially planned deficit according to the 2002 pre-accession economic programme. Against the background of faltering growth, this outcome was exactly as projected in the 2003 pre-accession economic programme (1.95 percent). Note that a revision of the government accounts, linked to the sectoral re-classification of some public institutions, has recently raised the general government deficit figures for the period 2000-2003 (by 0.2-0.5 percent of GDP). Fiscal performance was satisfactory in 2003. On the revenue side, taxes on profits and capital gains increased markedly, while substantial savings on interest expenditure materialised due to lower-than-anticipated inflation.

The Commission services project the general government deficit to worsen in 2004. Applying the old methodology, the convergence programme foresaw a deficit of 1.9 percent of GDP. Despite the anticipation of an economic rebound, this target was set slightly higher than previous year’s outcome and is due to growing deficits of the central government as structural reforms are moving forward only slowly. With fiscal policy geared to reducing the structural deficit, measures in the 2004 budget mostly apply to the restructuring of spending. Furthermore, the agreement on public sector wages for 2004-2005 introduced forward-looking indexation mechanisms. A new wage adjustment method, taking into account expected domestic inflation, inflationary

expectations in the EU and the expected growth in the tolar/euro exchange rate, is deemed to contain budget expenditure given that wages constitute an important part of general government spending. Moreover, indexation of some social benefits has also been weakened. The government is committed to adhering to the targets. It is within its discretion to reduce expenditure proportionally – up to 15 billion tolar (0.25 percent of GDP) – to a revenue shortfall in the course of the year, without having to propose the budget to be amended. On the other hand, an up to 10 billion tolar (0.2 percent of GDP) higher deficit would be allowed in case of unfavourable macroeconomic trends.

The Slovene convergence programme, which covers the period 2004-2007, was examined by the Council on 5 July 2004[61]. Based on a plausible macroeconomic scenario, the budgetary strategy underlying the programme aims at achieving sound public finances as defined by a budgetary position of close-to-balance. To this end, the programme envisages cuts in both the revenue and the primary expenditure ratio – the former through a direct tax reform and the latter through restraint on mandatory expenditure – resulting in a gradual reduction of the general government deficit over the period covered.

The general government deficit is projected to narrow from 2.0 percent in 2003 to 0.9 percent in 2007. By postponing the deficit reduction to the far end of the programme horizon, the programme projects a back-loaded fiscal consolidation whereby a close-to-balance position is only approached, not reached. The budgetary stance in the programme is therefore not consistent with the Stability and Growth Pact's medium-term objective of a budgetary position of close-to-balance or in surplus.

Furthermore, risks to keeping the deficit under control cannot be excluded. Should the authorities not succeed in limiting the play of fiscal stabilisers there may not be a sufficient safety margin against breaching the 3 percent of GDP deficit threshold, especially in the initial years of the programme period. Beyond 2005, however, budgetary projections appear credible as the macroeconomic scenario seems to reflect plausible growth forecasts, anticipating real GDP to grow slightly above potential output at 3.7 percent and assuming that the restructuring process continues.

Following a steady upward trend, gross public debt stayed at slightly less than 30 percent of GDP in 2003. Over the medium-term horizon of the convergence programme, the debt ratio will remain relatively low although the government anticipates a further rise in the first two years given the persistent primary deficit. After increasing until 2005, the debt ratio is expected to fall back to 28.4 percent of GDP in 2007.

61 See footnote 45.

Table 4.15
Slovenia: budgetary developments

(as percentage of GDP unless indicated otherwise)

		1998	1999	2000	2001	2002	2003	2004(*)
General government balance		:	:	-3.5	-2.8	-2.4	-2.0	-2.3
- Total revenue		:	:	44.7	45.1	45.7	46.2	45.3
- Total expenditure		:	:	48.2	47.9	48.1	48.2	47.7
of which :	- Interest expenditure	:	:	2.4	2.4	2.3	2.1	2.0
	- Primary expenditure	:	:	45.7	45.5	45.7	46.1	45.6
	- GFCF	:	:	3.1	3.0	2.8	2.8	2.8
Primary balance		:	:	-1.0	-0.4	0.0	0.1	-0.3
pm Tax burden		:	:	39.3	39.4	39.8	40.4	40.2
Government debt		23.6	24.9	27.4	28.1	29.5	29.4	30.8
pm Real GDP growth (%)		3.6	5.6	3.9	2.7	3.3	2.5	4.0
pm HICP inflation (%)		7.9	6.1	8.9	8.6	7.5	5.7	3.9

(*) Forecast

Source: Commission services

4.4.10. Slovakia

The development of the general government deficit between 1998 and 2003 was heavily influenced by exceptional factors, mainly related to bank restructuring and government guarantees, which resulted in particularly high capital transfers in the years 1999 and 2000 of roughly 6 and 8 percent of GDP respectively. Accordingly, the deficit peaked in 2000 at over 12 percent of GDP but fell to 3.7 percent of GDP in 2003.

Adjusting for the exceptional factors suggests that fiscal consolidation efforts strengthened in 1999 (as part of a macroeconomic stabilisation package) but weakened again in the run-up to the 2002 election – in spite of growth accelerating from 1.5 percent in 1999 to 4.4 percent in 2002. Fiscal consolidation efforts during this period were of a rather ad-hoc nature and not sufficiently embedded in a medium-term fiscal framework. Expenditure overruns, notably in social transfers, were frequent and the attainment of budgetary targets sometimes depended on across-the-board cuts or compression of the least protected expenditure categories during the budget year.

In the budget for 2003, a newly formed government started to implement its agenda of structural public expenditure reforms and kept expenditures much better under control during budget execution than in previous years, including in the area of social transfers. In addition, in particular due to substantial under-spending in the areas of government consumption, subsidies and capital outlays, expenditures turned out some 2 percent of GDP lower than budgeted. This was to some extent supported by ½ percentage point higher-than-expected real growth of 4.2 percent. In contrast, on the revenue side, the higher GDP growth could not compensate for far too optimistic budgetary projections, in particular on VAT receipts, in the context of changes in tax rates and assessment procedures. Revenues underperformed substantially and were some 3/4 percent of GDP lower than planned.

The budget for 2004 targets a general government deficit of 4.0 percent of GDP, as confirmed by the convergence programme. The budget reflects most of the government's structural reform agenda for the current legislative period, both on the revenue and expenditure side. It constitutes an important step to place public finances on a more sustainable footing and to increase their quality. On the revenue side, it incorporates a comprehensive tax reform package, which is expected to be basically revenue-neutral and constitutes a major shift from direct to indirect taxation. On the expenditure side, reform measures in the areas of pensions, sickness benefits, social assistance, social benefits and health care are likely to lead to sustained savings in mandatory spending, whereas

expenditure increases are mostly implemented in more discretionary areas, such as gross fixed capital formation. Subsidies are planned to increase as well. Budget execution figures available to date confirm the attainability of the deficit target. Downside risks could result from additional spending pressures. Altogether, the risks in 2004 would appear to be somewhat tilted to the positive side.

The Slovak convergence programme, which covers the period 2004-2007, was examined by the Council on 5 July 2004[62]. The budgetary strategy underlying the programme aims at reducing the general government deficit to 3.0 percent of GDP by 2007. The reduction in the deficit is expected to occur mainly in 2007. The programme envisages an adjustment based on primary expenditure reductions of 1.5 percentage points of GDP over the period, underpinned by the mentioned structural reforms, which are mostly already enacted and in force. In addition, a funded pension pillar will be introduced in 2005, which leads to a revenue decrease for general government, amounting to 1 percent of GDP by 2007 (included in the above-mentioned deficit figure).

The macroeconomic scenario underlying the programme seems to reflect broadly plausible growth assumptions, including an acceleration of growth to around 5 percent in 2006 and 2007 – due to further strengthening exports on the back of an FDI-induced expansion of export capacity. The risks to the budgetary projections over the programme horizon appear broadly balanced. Downside risks seem to be concentrated on the expenditure side.

The dynamics of the debt ratio between 1998 and 2003 were dominated by extraordinary factors: on the one hand, bank restructuring operations and debt assumptions related to government guarantees led to a sharp increase of the debt ratio in 1999 and 2000; on the other hand, major privatisation projects mitigated the increase in the debt ratio and contributed to its fall in 2001 and 2002 to around 43 percent of GDP. The convergence programme expects an increase in the debt ratio by roughly 2½ percentage points in 2004, predominantly owing to stock-flow adjustments. After a further increase in 2005, it predicts a decline to 45½ percent of GDP by 2007.

62 See footnote 45.

Table 4.16
Slovakia: budgetary developments

(as percentage of GDP unless indicated otherwise)

		1998	1999	2000	2001	2002	2003	2004(*)
General government balance		-3.8	-7.1	-12.3	-6.0	-5.7	-3.7	-3.9
- Total revenue		57.1	49.8	47.6	45.5	45.2	35.4	35.8
- Total expenditure		60.8	56.9	59.9	51.5	50.9	39.2	39.7
of which :	- Interest expenditure	2.4	3.4	4.1	4.0	3.6	2.5	2.4
	- Primary expenditure	58.4	53.5	55.9	47.5	47.3	36.6	37.3
	- GFCF	4.0	2.9	2.8	3.1	3.3	2.6	2.9
Primary balance		-1.4	-3.8	-8.2	-2.0	-2.1	-1.2	-1.6
pm Tax burden		38.4	36.0	34.4	32.9	33.1	31.2	29.4
Government debt		34.0	47.2	49.9	48.7	43.3	42.6	44.5
pm Real GDP growth (%)		4.2	1.5	2.0	3.8	4.4	4.2	4.8
pm HICP inflation (%)		6.7	10.4	12.2	7.2	3.5	8.5	7.7

(*) Forecast

Source: Commission services

4.4.11. Sweden

4.4.11.1. Situation in the 2002 Convergence Report

In the 1998 Convergence Report[63], the Commission considered that the excessive deficit situation in Sweden had been corrected. In the light of this assessment and in parallel with the adoption of the report, the Commission made a recommendation to the Council that the Decision of 10 July 1995 on the existence of an excessive deficit in Sweden should be abrogated. Acting on this recommendation the Council adopted on 1 May 1998 a decision abrogating the decision on the existence of an excessive deficit in Sweden[64]. In the 2000 and the 2002 Convergence Reports[65], the Commission considered that Sweden continued to fulfil the criterion on the government budgetary position.

4.4.11.2. Assessment of public finances in 2004

Swedish public finances have been in good shape in recent years; surpluses were recorded in each year between 1998 and 2001 and, after a marginal deficit in 2002, a surplus of 0.3 percent of GDP was recorded in 2003.

After having achieved an ambitious and successful fiscal consolidation of mainly structural nature in the five years to 1998, resulting in a surplus that year, the cyclically-adjusted government balance declined by 0.7 percentage points of GDP between 1999 and 2003. A significant fiscal easing in 2001 and 2002, comprising also income tax cuts, contributed to this. This considerable fiscal easing was facilitated by the strong budgetary position, and the cyclically-adjusted surplus of 1.0 percent of GDP in 2003 suggests that the Swedish public finances remain relatively favourable.

The 2003 update of the Swedish convergence programme covering the period 2004-2006 was examined by the

63 COM (1998) 1999, 25.3.1998.
64 OJ L 139, 11.5.1998, p. 19.
65 COM (2000) 277 final, 3.5.2000 and COM (2002) 243 final, 22.5.2002.

Table 4.17
Sweden: budgetary developments

(as percentage of GDP unless indicated otherwise)

		1998	1999	2000	2001	2002	2003	2004(*)
General government balance		1.8	2.5	5.1	2.8	0.0	0.3	0.6
- Total revenue		62.7	62.7	62.4	60.0	58.1	58.4	58.0
- Total expenditure		60.8	60.2	57.3	57.2	58.1	58.1	57.3
of which :	- Interest expenditure	5.6	4.6	4.1	3.2	2.9	1.9	2.1
	- Primary expenditure	55.3	55.5	53.3	53.9	55.1	56.1	55.2
	- GFCF	3.2	3.2	2.9	3.1	3.3	3.1	3.0
Primary balance		7.4	7.1	9.2	6.0	2.9	2.3	2.7
pm Tax burden		53.8	54.5	54.7	52.9	51.0	51.4	51.1
Government debt		68.1	62.8	52.8	54.4	52.6	52.0	51.6
pm Real GDP growth (%)		3.6	4.6	4.3	0.9	2.1	1.6	3.7
pm HICP inflation (%)		1.0	0.6	1.3	2.7	2.0	2.3	1.1

(*) Forecast

Source: Commission services

Council on 20 January 2004[66]. The updated programme projects gradually rising government surpluses over the period, with a projected surplus of 1.9 percent of GDP in 2006, in compliance with the Stability and Growth Pact's medium-term objective of a budgetary position close-to-balance or in surplus. The national budgetary strategy of a surplus of 2 percent of GDP on average over the cycle is maintained. This strategy is supported by expenditure ceilings on central government set three years ahead, extended to 2006 with this update. In addition, there is a balanced budget requirement for local government as stipulated by law since 2000.

In the Budget Bill for 2005 presented to Parliament by the Swedish government on 20 September 2004, the surplus in government finances is expected to be 0.7 percent of GDP in 2004 and thereafter gradually to rise slightly to a projected 0.9 percent of GDP in 2007.This implies a downward revision of the budgetary situation vis-à-vis the 2003 update of the convergence programme. The Budget Bill supersedes the macroeconomic scenario and budgetary plans and projections included in the updated convergence programme. The plans and projections of the Budget Bill appear broadly plausible[67].

The government debt ratio in Sweden has been on a declining trend since 1994 and has been below the reference value of 60 percent of GDP since 2000. In 2003, the debt ratio was 52 percent of GDP. In 2004 the debt ratio is expected by the Commission services to be slightly lower. According to the Swedish authorities' most recent projections (in the Budget Bill for 2005), the debt ratio is expected to decline further in the years to 2007.

66 OJ C 29, 3.2.2004.

67 However, the downward revisions of the government budgetary position in coming years may be difficult to reconcile with the overall Swedish fiscal strategy of a surplus of 2 percent of GDP on average over the cycle.

5. EXCHANGE RATES

5.1. Treaty provisions and assessment of exchange rate stability

The third indent of Article 121 refers to the exchange rate criterion as *"the observance of the normal fluctuation margins provided for by the exchange-rate mechanism of the European Monetary System, for at least two years, without devaluing against the currency of any other Member State"*.

Article 3 of the Protocol on the convergence criteria stipulates: *"The criterion on participation in the exchange rate mechanism of the European Monetary System (…) shall mean that a Member State has respected the normal fluctuation margins provided for by the exchange-rate mechanism of the European Monetary System without severe tensions for at least the last two years before the examination. In particular, the Member State shall not have devalued its currency's bilateral central rate against any other Member State's currency on its own initiative for the same period"*.

With the launch of the euro, the European Monetary System has been replaced by the exchange-rate mechanism II. This mechanism links the currencies of participating Member States to the euro, which is at the centre of the mechanism.

None of the eleven Member States with a derogation has participated for two years in ERM II during the review period. As a result, none of them meet the exchange rate criterion.

5.2. Exchange rate movements of Member State currencies

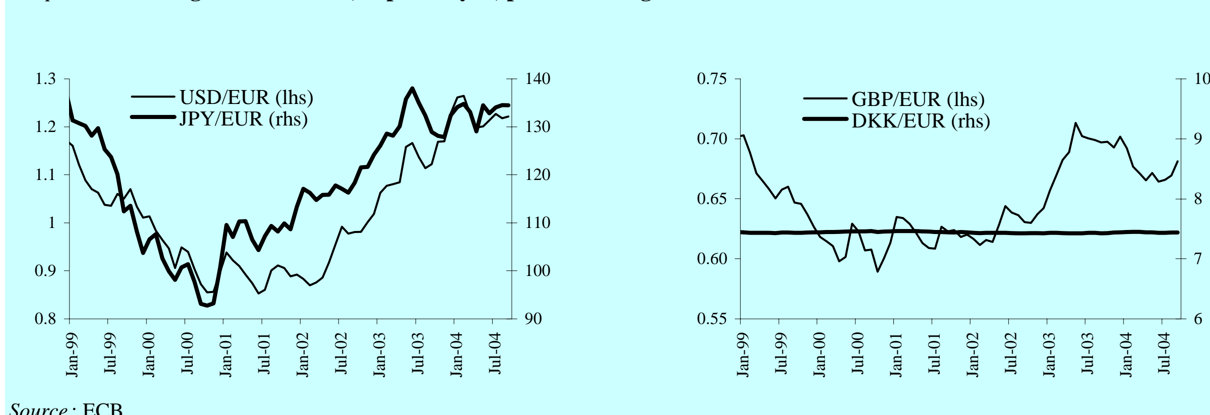
5.2.1. Overall conditions in exchange markets

While developments in foreign exchange markets since the inception of the euro had been marked by the general rise in the US dollar, the last 2½ years have witnessed a broad depreciation of the US dollar that was mirrored by an appreciation of the euro. After passing parity vis-à-vis the US dollar in mid-2002, the euro has been on a steady upward trend and maintained its strength vis-à-vis the dollar in mid-2004. The exchange rate of the euro increased by about 38 percent from 0.88 USD in January 2002 to 1.22 USD in September 2004[68], thereby exceeding the level at which the single currency had been traded at the start of Stage III of EMU (1.16 USD in January 1999). In mid-2004, the USD-EUR exchange rate stood close to its long-run average.

Within the EU-15, the pound sterling depreciated by 10 percent between January 2002 and September 2004 (from 0.62 EUR to 0.68). The Danish krone remained within a narrow margin around its ERM II-central parity.

[68] All figures are monthly averages.

Graph 5.1 : **Euro against US dollar, Japanese yen, pound sterling and Danish krone**



Source : ECB

5.2.2. ERM II currencies

As of 28 June 2004, the Estonian kroon, the Lithuanian litas and the Slovenian tolar participate in ERM II with a standard fluctuation band of ±15 percent around their central rate. Estonia and Lithuania have announced their intention to unilaterally maintain their currency board in ERM II.

Estonia has been operating a currency board regime since the reintroduction of the kroon in 1992. With the kroon initially pegged to the German mark, the peg was

Box 5.1: Euro central rates and compulsory intervention rates in ERM II

Following the decisions taken on 27 June 2004 on the euro central rates in ERM II for the Estonian kroon, the Lithuanian litas and the Slovenian tolar, the compulsory intervention rates for these currencies have been established with effect from 28 June 2004. They are:

Currency		EUR 1 =
Estonian kroon (EEK)	Upper rate	17.9936
	Central rate	15.6466
	Lower rate	13.2996
Lithuanian litas (LTL)	Upper rate	3.97072
	Central rate	3.45280
	Lower rate	2.93488
Slovenian tolar (SIT)	Upper rate	275.586
	Central rate	239.640
	Lower rate	203.694

switched to the euro as of 1 January 1999, at a rate of 15.6466 kroon per euro.

Estonia's currency board arrangement is fairly orthodox. The Law on the Security of the Estonian kroon, which is the legal basis for the currency board arrangement, requires that all domestic liabilities of the central bank (in particular currency in circulation and deposits with the central bank) are backed up by foreign currency reserves or gold. The law guarantees full convertibility of the kroon at the parity rate and permits the issue of new currency only against a corresponding change in reserves.

During the last decade, the currency board arrangement has been backed up by prudent fiscal policies, open markets, a robust financial sector and a relatively flexible economy. The currency board system has also withstood shocks, such as a domestic mini-boom in 1997 (which the Asian crisis helped to deflate) and the Russian crisis in 1998; strong policies were key in these instances.

On 28 June 2004, the kroon started to participate in ERM II with the central rate set at the parity rate prevailing in the currency board arrangement. The Estonian authorities have committed to unilaterally maintain the currency board in the mechanism. There has been no deviation from the central rate since the kroon's participation.

Lithuania has been operating a currency board regime since April 1994 with the litas initially pegged to the US dollar at LTL 4 per USD. In February 2002, the litas' peg was switched to the euro at the prevailing market rate of LTL 3.4528 per euro.

Pursuant to the Litas Credibility Law, the Bank of Lithuania guarantees that the total amount of litas put into circulation does not exceed gold and foreign exchange reserves. In practice, the ratio of official reserve assets to the monetary base has well exceeded 100 percent, underpinning the credibility of the currency board arrangement.

During the last decade, the currency board arrangement has served as a disciplining force for imposing and maintaining prudent fiscal policies and external sustainability. The currency board has also proven to withstand shocks, such as the banking crisis of 1996 and the Russian crisis in 1998, which in combination with a severe recession and a worsening fiscal position put the system under substantial strain. Corrective policy measures, including significant fiscal adjustment and structural reforms, helped to restore growth and capital inflows and supported the credibility of the currency board arrangement.

On 28 June, the litas started to participate in ERM II with the same central rate. The Lithuanian authorities have committed to unilaterally maintain the currency board in the mechanism. There has been no deviation from the central rate since the litas' participation.

Before joining ERM II on 28 June 2004, the Bank of *Slovenia* conducted monetary policy through a combination of interest rate policy and exchange rate management. The Bank set interest rates with a view of controlling domestic demand in line with its inflation objective. In order to prevent interest-rate sensitive capital inflows, the Bank of Slovenia engineered a continuous depreciation of the exchange rate in such a way that the capital loss through the depreciation offset the higher revenue from the interest rate differential (uncovered interest rate parity).

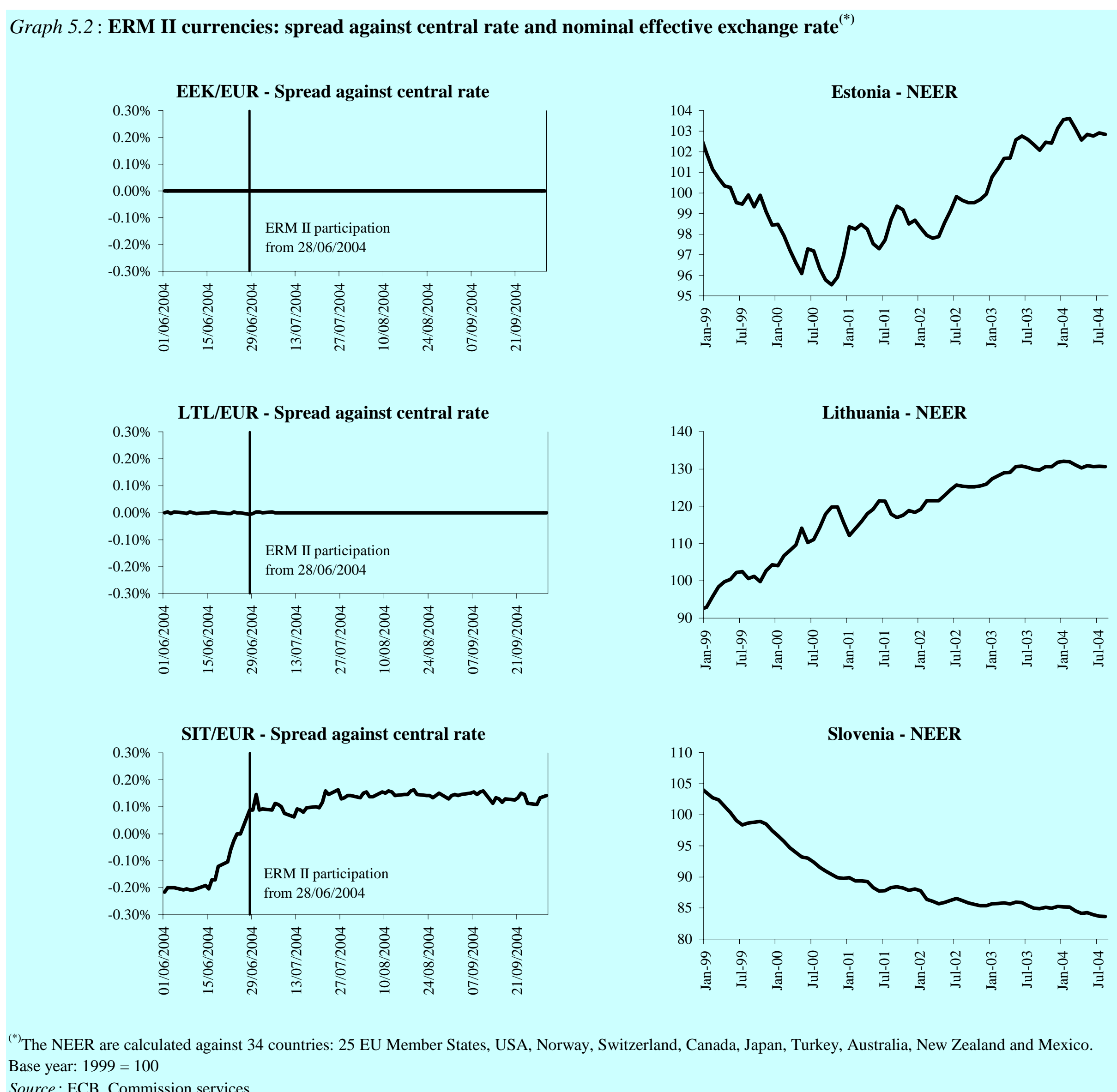
Active exchange rate management has resulted in a smooth depreciation of the tolar against the euro. Before participating in ERM II at the end of June 2004, the tolar had depreciated by 9 percent against the euro compared to January 2002. In nominal effective terms, it had depreciated by 5 percent over the same period.

While in 2002 the main refinancing rate had been rather stable, the Bank of Slovenia cut it in 2003 by a cumulative 225 basis points. A better inflation outlook allowed the Bank to lower the main refinancing rate further in 2004. In September 2004, the main refinancing rate stood at 3 percent, compared to 2 percent in the euro area.

In line with the strategy towards ERM II and euro adoption published in November 2003, the authorities started to stabilise the exchange rate upon ERM II participation, in line with the convergence of interest

rates. Since its participation in ERM II, the tolar has been trading close to its central rate of 239.640 tolar per euro. The average deviation has been .13 percent, while the maximum deviation from the central rate reached .16 percent. The monetary authorities have sporadically intervened on the foreign exchange market.

Graph 5.2 : **ERM II currencies: spread against central rate and nominal effective exchange rate**[(*)]



[(*)]The NEER are calculated against 34 countries: 25 EU Member States, USA, Norway, Switzerland, Canada, Japan, Turkey, Australia, New Zealand and Mexico.
Base year: 1999 = 100
Source : ECB, Commission services

5.2.3. Developments in non-ERM II currencies

Exchange rate developments of non-ERM II currencies are reviewed in the context of the exchange rate strategies pursued by the authorities

5.2.3.1. The pegged currencies: the Cyprus pound, the Hungarian forint, the Latvian lats and the Maltese lira

While the Cyprus pound and the Hungarian forint are pegged to the euro, the Latvian lats and the Maltese lira are pegged to a basket of currencies[69].

Since its independence in 1960, monetary policy in *Cyprus* has been conducted through an exchange rate target, which has been historically understood as a tool to maintaining macroeconomic stability and low inflation. After having been pegged to different anchors, be it one currency (pound sterling or US dollar) or a basket of currencies, Cyprus re-pegged in 1992 the pound to the ECU with fluctuation margins of ±2.25 percent. The peg has been redirected towards the euro since January 1999 with a central rate of .5853 pound per euro. Following progress with capital account liberalisation in 2001, the fluctuation band has been widened to ±15 percent in August 2001, although the exchange rate has continued to be *de facto* traded in a narrow band.

The central bank raised interest rates by 100 basis points at the end of April 2004 for the first time in several years in a precautionary move linked to the completion of the liberalisation of the capital account as of 1 May 2004, bringing the marginal lending facility rate to 5.5 percent. Rates were kept unchanged since then. The pound subsequently started to slowly appreciate and, at the end of September 2004, was trading slightly above its central rate (by 1.4 percent) and 0.2 percent above its January 2002 level.

Reflecting the developments in the ECU/euro exchange rate, the nominal effective exchange rate of the Cyprus pound has followed a slow but sustained appreciation path since 1994, with the exception of the 1999-2000 period when the euro depreciated against the US dollar. In September 2004, it stood 7.7 percent above the January 2002 level.

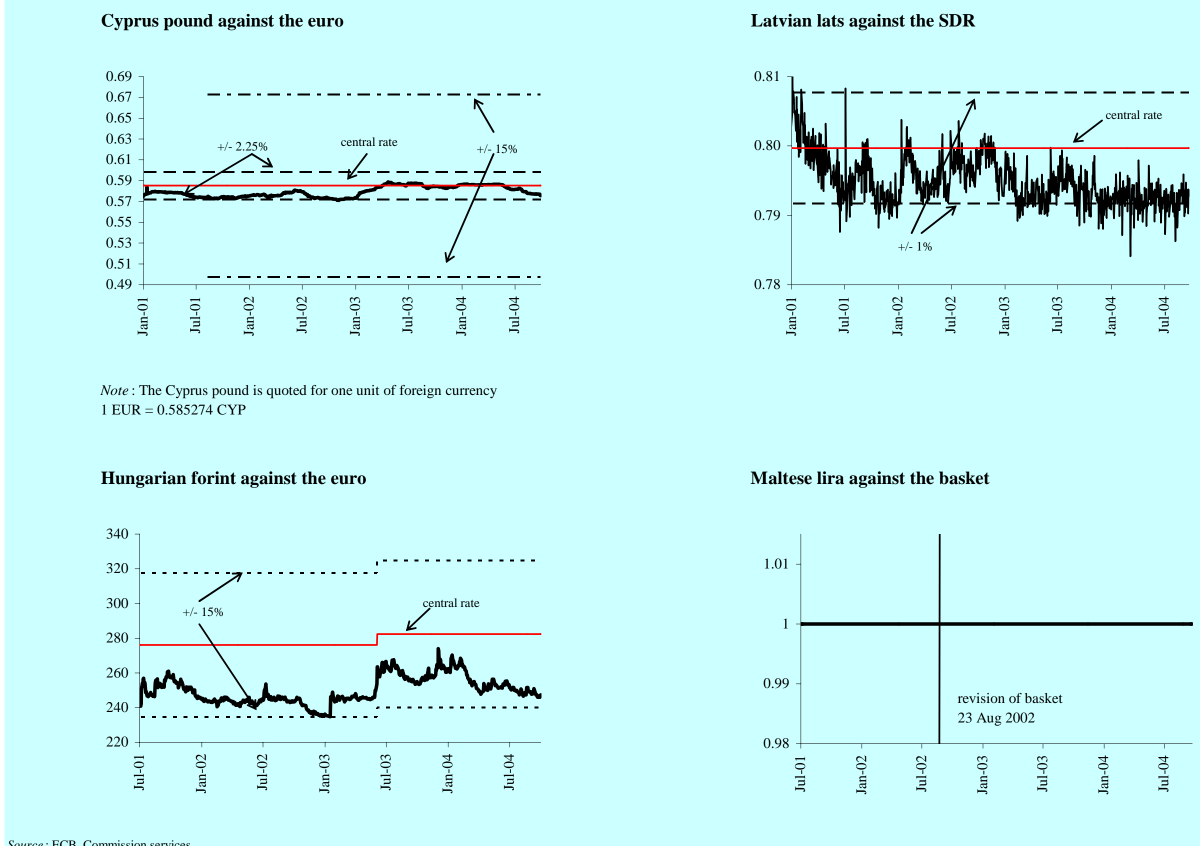
In the mid-1990s, *Hungary* operated a crawling peg regime based on a narrow exchange rate corridor. The currency was kept within a ±2.25 percent band around a reference rate which, in the last stage of the regime in 2001, was depreciated by 0.2 percent a month. The regime helped to lower inflationary expectations and inflation fell from over 25 percent to below 10 percent in mid-2001.

Since October 2001, the National Bank of Hungary operates an inflation targeting framework in combination with an exchange rate peg. The forint is pegged to the euro with a ±15 percent fluctuation band around a central parity. The central parity of the forint was unchanged from 1 October 2001 – the date of abolition of the former crawl – until 4 June 2003, when it was devalued by 2.26 percent from 276.1 to 282.4 forint per euro.

Monetary policy has been aiming at controlling inflation by keeping the exchange rate in the stronger half of the fluctuation band. With the forint appreciating towards the limit of the band in early 2003, despite a reduction of interest rates by a total of 100 bps in late 2002, policy rates were further reduced from 8.5 to 6.5 percent. In June 2003, the government decided, in agreement with the central bank, to devalue the central parity of the forint by 2.26 percent to its present level. Official communication stressed the need to prevent an excessive appreciation of the currency and to contribute to improving international competitiveness of the Hungarian economy. The ensuing capital outflows triggered a decline in the forint beyond what was judged to be desirable from the perspective of controlling inflation. Policy rates were increased by a cumulative 300 basis points in June 2003 and again in November to 12.5 percent.

In early 2004, the forint strengthened again, allowing the central bank to gradually lower policy rates despite continued inflationary pressures. By September 2004, the base rate had been reduced by a total of 150 basis points in four steps, to 11 percent. The Monetary Council pointed to a better assessment by foreign investors of the risks facing the Hungarian economy, which made it possible to reduce the earlier high risk premium. Also, the bank revised downwards its

69 Both Latvia and Malta will need to change their exchange rate regime to participate in ERM II, as pegs to other currencies than the euro are not compatible with the mechanism.



inflation forecast to around 6 percent for December 2004 and between 4 to 5 percent at year-end 2004 and 2005 respectively.

Since April 2004, the forint has stabilised in a range of 246-256 forint per euro. At the end of September, the forint was trading at 247 forint per euro, some 12 percent stronger than its central parity, and 2 percent below its January 2002 level. On an effective basis, the forint has appreciated by 3 percent since January 2002.

Since February 1994, the Bank of *Latvia* has been operating an exchange rate regime under which the lats is pegged to the SDR basket of currencies – at the fixed rate 0.7997 lats per SDR[70] – in order to achieve its primary objective of price stability. The fluctuation band around the fixed peg rate is ±1 percent, with the Bank of Latvia committed to intervene to keep the lats exchange rate within the fluctuation margins.

In recent years, the lats has been trading in the stronger half of the fluctuation band. Following the general USD appreciation throughout 1999 and most of 2000, the lats also appreciated vis-à-vis the euro. The euro-lats exchange rate stabilised in 2001 and the currency subsequently depreciated in 2002 and 2003, as the euro appreciated against all other SDR basket currencies. Between January 2002 and September 2004, the lats depreciated against the euro by around 18 percent, returning to approximately the same levels as seen in the beginning of 1999.

A similar development took place in nominal effective terms. The effective exchange rate of the lats rose in 1999 and most of 2000 in line with the general rise of the US dollar. Following the stabilisation of the euro-dollar exchange rate in 2001 and the significant

70 The currency weights in the SDR basket are (in percent): USD 45, EUR 29, JPY 15, and GBP 11.

appreciation of the euro in 2002 and 2003 against other SDR basket currencies, the nominal effective exchange rate of the lats declined and was in September 2004 some 10 percent below its January 2002 level, approximately the same levels as seen in the beginning of 1999.

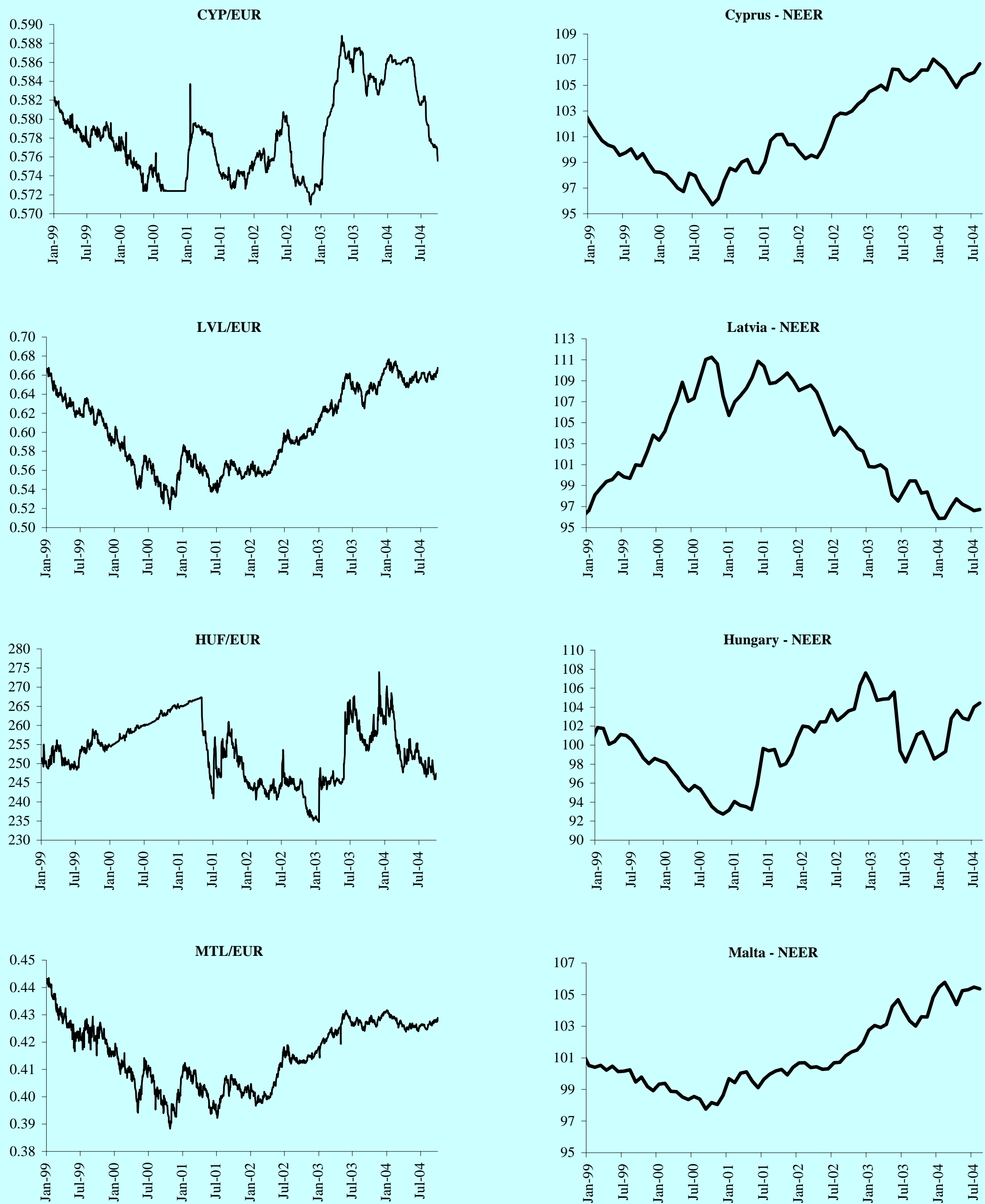
The combination of a fixed exchange rate and free capital movements constrains the Bank of Latvia's ability to independently set monetary policy rates. The refinancing rate has been lowered on several occasions since the mid-1990s, with the latest rate by 0.5 percentage points to 3 percent occurring in September 2002. In March 2004, the Bank of Latvia's Board of Governors increased the refinancing rate by 0.5 percentage point to 3.5 percent.

Since its independence in 1964, *Malta* has maintained a pegged exchange rate regime – with an at-par peg of the Maltese lira to the pound sterling, followed since the early 1970s by pegs to changing currency baskets. Within this regime, the only exchange rate realignment occurred in 1992, when the lira was devalued by 10 percent against the basket in response to devaluations by major trade partners and competitors in the context of the ERM crisis. The current basket is composed of the euro, the US dollar and the pound sterling, whose respective shares were set at 70 percent, 10 percent and 20 percent when the basket was last revised in August 2002.

Due to the dominant share of the euro in the basket, fluctuations in the Maltese lira/euro rate have been limited to around ± 3.5 percent on average over the past years. In 2003, the lira depreciated against the euro compared to its end-2002 level, while it appreciated substantially against other reserve currencies such as the dollar, the yen and the pound sterling. In early 2004, some of these movements were reversed as the euro eased against other major currencies. In September 2004, the lira stood some 7 percent lower against the euro compared to January 2002. In nominal effective terms, the Maltese lira has appreciated by some 5 percent over the same period.

After having cut several times between 2001 and 2003, the central bank has maintained the policy rate at 3 percent (100 points above the euro area level), unchanged since September 2003.

Graph 5.4: **Pegged currencies: bilateral exchange rate against the euro and nominal effective exchange rate**(*)



Source : ECB, Commission services

(*)The NEER are calculated against 34 countries: 25 EU Member States, USA, Norway, Switzerland, Canada, Japan, Turkey, Australia, New Zealand and Mexico. Base year: 1999 = 100

5.2.3.2. The floating currencies: the Czech koruna, the Slovak koruna, the Polish zloty and the Swedish krona

Following the creation of two independent states in 1993, both the Czech Republic and Slovakia inherited a system of a fixed peg within a ±0.5 percent band.

In 1997, following a period of economic overheating accompanied by large current account deficits and loose fiscal policy, the *Czech koruna* came under devaluation pressures and the peg was abandoned. Since 1998, the Czech National Bank has combined explicit inflation targeting with a managed exchange rate. The importance attached to the exchange rate has varied over time.

While in the past the central bank resisted what it considered as unfounded appreciation pressures, more recently the exchange rate has been left to fluctuate more freely. Following a period of quick interest rate convergence with the euro area, decisions of the central bank started to mirror those of the ECB and the interest rate differential disappeared in mid-2002. In response to a strengthening growth momentum potentially leading to inflationary pressures, the Czech National Bank during summer 2004 raised the refinancing rate by 50 basis points to 2.5 percent.

The Czech koruna experienced a long period of appreciation in effective terms, mainly driven by an appreciation against the euro. The appreciating trend was mainly attributed to substantial inflows of foreign direct investment associated with privatisation projects. In mid-2002 the trend reversed, mainly because of the slowdown of the privatisation process and the Central Bank's intervention against a "too quick" appreciation of the Czech koruna. After regaining some momentum in the second quarter of 2004, the koruna stabilised since June in a range of 31.2-31.9 koruna per euro and was trading at 31.7 koruna per euro at the end of September 2004, very close to its level of January 2002. In nominal effective terms, the koruna stood 6 percent above its January 2002 level.

Soon after its introduction in February 1993, the *Slovak koruna* came under pressure and the central rate was devalued by 10 percent in July 1993. Following a progressive liberalisation of the current and capital account, the Slovak central bank decided to widen the fluctuation band to ±5 percent in 1996 and to ±7 percent in 1997. Increasing external imbalances, the Russian crisis and political uncertainty resulted in further depreciation pressures, leading to the peg being abandoned in October 1998 and to a subsequent substantial depreciation of the currency. Since then, Slovakia has been operating a combination of implicit inflation targeting and managed float.

The koruna strongly appreciated against the euro after the adoption of an economic stabilisation program in May 1999, aimed at stabilising public finances and correcting external imbalances by controlling domestic demand. This appreciation trend stopped in mid-2000 and eventually reversed in the first half of 2002 when pre-election uncertainties and economic imbalances re-emerged. An improving macroeconomic outlook led to a surge in foreign direct investment and to renewed appreciation pressures since the second half of 2002. Together with market intervention, the central bank initiated a series of interest rate cuts of a cumulative 150 basis points in 2004 leaving the refinancing rate at 4.5 percent since June 2004. The appreciation trend stopped in July and August and the koruna lost around 1 percent in these two months. By September 2004, the Slovak koruna has appreciated by 6 percent against the euro since January 2002 and by 10 percent in effective terms over the same period.

Poland has implemented different monetary and exchange rate regimes in the course of its transition process. At the outset of transition, an exchange-rate based stabilisation strategy was implemented to fight hyperinflation. The zloty was first pegged to the dollar and later to a basket of currencies. In 1991, the regime was changed to a crawling peg – with a band around the central rate introduced in 1995 – combined with monetary targeting, with the aim to pursue disinflation while also taking account of competitiveness concerns (an approach known as "eclectic monetary policy"). Over time, tensions between the multiple goals of monetary and exchange rate policy became apparent and the National Bank of Poland switched to a direct inflation targeting framework in 1998. At the same time, the rate of crawl was slowed and the band around the depreciation path was widened and central bank interventions were progressively scaled back. Since April 2000, Poland operates a floating exchange rate regime, with the central bank abstaining from currency interventions.

Following an initial appreciation after the float, the exchange rate of the zloty has been depreciating against the euro since mid-2001. Its fall accelerated in the second half of 2003 as market uncertainty regarding fiscal consolidation increased. As the zloty remained relatively stable against the dollar, the depreciation was less pronounced in nominal effective terms. In early 2004, the zloty continued to depreciate vis-à-vis the euro, but it has since regained ground, standing in September roughly at its level of autumn 2003 and around 22 percent below its January 2002 level. In nominal effective terms, the zloty registered a modest further depreciation during the first five months of 2004 before recovering again, standing end-September about 15 percent above its level of January 2002.

During summer 2004, the National Bank of Poland raised the main reference rate by 125 basis points between June and August, to 6.5 percent. This first move since mid 2003 followed a very long period of monetary easing that started early 2001.

Compared to developments in previous years, the *Swedish* krona has been largely stable vis-à-vis the euro since 2002. Rising interest rate differentials contributed to an appreciation of the krona vis-à-vis the euro in the first half of 2002. Subsequently, the krona remained broadly stable vis-à-vis the euro, fluctuating in the interval SEK 8.9-9.5 per EUR, with an average of SEK 9.15 per EUR since January 2002. Following the referendum on euro adoption in autumn 2003 the krona appreciated against the euro and traded close to SEK 9.0 per EUR throughout the year. In the beginning of 2004, the krona again lost some ground vis-à-vis the euro, reflecting financial market expectations of a diminishing interest rate differential vis-à-vis the euro area. Since early April 2004, the krona had fluctuated around SEK 9.16 per EUR, but slightly appreciated in September to reach 9.05 SEK/EUR. By September 2004, the krona had appreciated by -1.5 percent against the euro compared to January 2002.

Based on the benign inflation outlook, the Riksbank lowered the key policy rate by 25 basis points from 2.75 percent to 2.50 percent in early February 2004 and further by half a percentage point to 2.00 percent in early April 2004, bringing the policy rate in line with that of the European Central Bank for the first time since November 2001.

Following almost two years of decline, the nominal effective exchange rate path of the krona reversed at the end of 2001. From January 2002 to September 2004, the nominal effective exchange rate of the krona rose by almost 11 percent, fully reversing the decline in the previous two years. Improved relative growth prospects, rising interest rate differentials and a slowdown in portfolio outflows – reflecting the completion of the portfolio reallocation following the technology sector crisis – were important factors in support of the Swedish currency. Given that the krona has been broadly stable vis-à-vis the euro since the beginning of 2002, the rise in the nominal effective exchange rate mainly reflects movements vis-à-vis the US dollar – against which the krona rose by 29 percent in the period January 2002 to September 2004 – and to a lesser extent vis-à-vis the currencies of Japan and Great Britain.

Graph 5.5: **Floating currencies: bilateral exchange rate against the euro and nominal effective exchange rate[(*)]**

Source : ECB, Commission services

[(*)]The NEER are calculated against 34 countries: 25 EU Member States, USA, Norway, Switzerland, Canada, Japan, Turkey, Australia, New Zealand and Mexico.
Base year: 1999 = 100

6. LONG-TERM INTEREST RATES

6.1. Treaty provisions

The fourth indent of Article 121(1) of the Treaty requires *"the durability of convergence achieved by the Member State and of its participation in the exchange rate mechanism of the European Monetary System being reflected in the long-term interest rate levels"*.

Article 4 of the Protocol on the convergence criteria further stipulates that *"the criterion on the convergence of interest rates (…) shall mean that, observed over a period of one year before the examination, a Member State has had an average nominal long-term interest rate that does not exceed by more than 2 percentage points that of, at most, the three best-performing Member States in terms of price stability. Interest rates shall be measured on the basis of long-term government bonds or comparable securities, taking into account differences in national definitions"*.

Long-term interest rates cannot be directly influenced by national authorities but reflect financial market participants' assessment of underlying economic conditions, including the credibility and sustainability of economic policies. The level of the long-term interest rate depends on the underlying real rate, the expected inflation rate and risk premia (related mainly to default on repayment of debt, expected exchange rate movements and uncertainty attached to inflation rate and exchange rate expectations). With liberalised capital markets in the Union, real rates tend to equalise across Member States. Therefore, differentials between the corresponding nominal rates mainly reflect how financial markets assess the prospects – in terms of inflation, soundness of public finances and exchange rate stability – of each Member State relative to the others[71].

6.2. Interest rate developments in major bond markets and the Member States

6.2.1. Global context

Much of the low level of global long-term bond yields in recent years is associated with the forward-looking and pre-emptive monetary policies in the major industrialised regions since 1999, which have generally managed to contain inflationary pressures and maintain price stability. Since the beginning of 1999, the average CPI inflation rate of the OECD area has fluctuated in the interval 1-3 percent. In the United States, CPI inflation has remained below 4 percent and has averaged 2½ percent since the beginning of 1999 while Japan has experienced deflation for most of the period. Euro area inflation, measured by the HICP, has averaged 2.0 percent in the same period and has fluctuated in the interval 1-3 percent for most of the period.

Reflecting strong economic activity, rising inflation expectations and higher short-term interest rates, the yield on the benchmark 10-year government bond in the United States rose by around 160 basis points in the course of 1999 to stand at 6.3 percent at the end of the year. Following the economic slowdown in 2000 and amid contained inflationary pressures, monetary policy in the US eased considerably in 2001. Reflecting these developments, and in spite of an increasing budget deficit in the US, the yield on the benchmark 10-year government bond fell to 3.3 percent by June 2003. Subsequently, the 10-year government bond yield has risen, to stand at 4.3 percent in August 2004, reflecting an end to concerns about deflationary pressures, an increasingly optimistic economic outlook, expectations of measured policy rate increases and rising inflation expectations.

Weak economic activity and persistent deflation have required a highly expansionary monetary policy in Japan during the period 1999-2004. Japanese bond yields accordingly remained at very low levels of below 2 percent during most of this period. The yield on the benchmark 10-year government bond reached in May 2003 a historic trough of below 0.6 percent before rising to 1.6 percent in August 2004, reflecting a more positive growth outlook and easing deflationary pressures.

Reflecting monetary tightening by the ECB and partly influenced by developments in the US bond

71 Differentials will also reflect differences in tax treatment and market liquidity.

market, euro area long-term bond yields rose on average by 130 basis points in the course of 1999, to 5.3 percent by the end of the year, before levelling off in the first half of 2000. In 2001, amid clear signs of lower inflationary pressures arising initially from weakening external demand – subsequently followed by sluggish growth in the euro area – and continued wage moderation, the monetary policy stance eased. In the following years, geopolitical uncertainties, the significant and rapid appreciation of the euro and downside risks to economic activity contributed to somewhat lower inflationary pressures over the medium term and the key ECB rate was further reduced to 2.0 percent in mid-2003. Long-term bond yields accordingly trended downward during this period, much in line with bond market developments in the US. The average yield on benchmark 10-year government bonds in the euro area reached a trough in June 2003 at 3.7 percent, reflecting financial market participants' more pessimistic growth outlook and receding medium-term inflationary pressures. Since mid-2003, the average yield on benchmark 10-year government bonds in the euro area has risen and stood at 4.2 percent in August 2004, partly owing to influences from the US bond market as well as shifting expectations of euro area monetary policy rates, rising uncertainty about medium-term inflation prospects and a slightly more optimistic economic outlook.

6.2.2. Long-term interest rates in the Member States with a derogation

6.2.2.1. Overall developments

The level of long-term interest rates in most Member States with a derogation has declined substantially over the past five years, due to lower short-term interest rates combined with an improvement in inflationary expectations and a decline in risk premia, but also reflecting developments in major bond markets, where contained inflationary pressures and low policy rates have contributed importantly to the low level of long-term bond yields.

Since the beginning of 2001, long-term interest rates in most new Member States have converged downward as shown in Graph 6.1[72]. This favourable evolution is consistent with a sustained improvement in medium-term inflationary expectations and a decrease in country-specific risk premia. Reflecting enhanced medium-term prospects for macroeconomic stability and sound policies, sovereign ratings have been upgraded for most of the new Member States, which has further contributed to decreasing the level of their long-term interest rates and the spread vis-à-vis the euro area. For a number of countries, a high degree of nominal exchange rate stability has arguably also been a contributing factor, although the decisive element appears to be the overall credibility of the monetary regime.

In the beginning of 2001, the countries with the highest long-term interest rates among the new Member States were Lithuania and Poland (with rates in the range of 9½-10½ percent) while the country with the lowest long-term interest rate was Malta (6.1 percent). In August 2004, Hungary and Poland had the highest long-term interest rates among the new Member States (with rates above 7 percent) while the countries with the lowest long-term interest rates were Lithuania, Malta and Slovenia (all with rates around 4.6-4.7 percent). Excluding Hungary and Poland – where developments in long-term interest rates have diverged from euro area developments in the recent past and where rates currently stand well above the euro area average –the degree of long-term interest rate convergence among new Member States is strong. In the group of new Member States excluding Hungary and Poland, the spread between the highest and the lowest long-term interest rates declined from 2.0 percentage points on average in 2001 to around 0.9 percentage points on average in the period January-August 2004, clustered within a range of 0.4 percentage points (Lithuania) and 1¼ percentage points (Cyprus) above the euro area average.

72 Harmonised series of long-term interest rates for convergence assessment purposes for the new Member States do, in most cases, not extend further back than to the beginning of 2001. Estonia has been excluded from the comparisons in the following paragraph due to the absence of a harmonised benchmark long-term government bond or comparable security (see Box 6.1).

6.2.2.2. Country-specific developments

At the beginning of 2001, the *Czech Republic* enjoyed one of the lowest long-term interest rates among the new Member States and the long-term bond yield has continued to decline, temporarily dropping below euro area rates between mid-2002 and mid-2003. Against the background of low inflationary pressures, monetary policy was eased significantly in the Czech Republic between mid-2001 and mid-2003. Subsequently, in June 2004, the Czech national bank began to increase its policy rates to counter risks to price stability. The long-term interest rate spread vis-à-vis the euro area stood in August 2004 at 0.9 percentage points.

Estonia does not set independent policy interest rates; monetary impulses from the euro area are directly transmitted to the domestic money market through the operation of its currency board. Money market spreads vis-à-vis the euro area have been decreasing since 2001 and remained relatively stable at around ½ percentage points since the beginning of 2003. Bank lending rates in Estonia[73], which are not directly comparable to government bond yields, were still quite high in mid-2002 but have declined sharply toward the euro area level since then, reflecting both lower short-term rates and increased competition in the banking sector.

In *Cyprus*, long-term interest rates declined considerably early 2002 and the long-term interest rate spread vis-à-vis the euro area remained within 1 percentage point for most of 2003. At the end of April 2004, the central bank increased policy rates by 100 basis points in a precautionary move linked to the completion of the liberalisation of the capital account on the eve of EU accession. Following this move, the June auction of 10-year government bonds yielded an average interest rate around 2¼ percentage points above the euro area level. Given the absence of a secondary bond market in Cyprus and an overall stable macroeconomic environment, this increase of long-term interest rates could in addition to higher short-term rates also reflect specific liquidity conditions at the time of the auction. In August 2004, Cyprus' long-term interest rate spread vis-à-vis the euro area stood at 2.4 percentage points.

Following several years of policy rate cuts to bring interest rates closer to euro area levels, monetary policy rates were recently raised in *Latvia* to prevent current high inflation rates from impacting negatively on inflation expectations and future inflation. Long-term interest rates in Latvia declined considerably toward euro area levels in the course of 2001 and 2002. Following short periods of very low long-term interest differentials vis-à-vis the euro area during 2002, the differential has since then increased slightly to levels around ¾ of a percentage point. Long-term yield spreads vis-à-vis the euro area are now significantly lower than spreads at the short end of the curve.

Lithuania operates a currency board regime and do not set independent policy interest rates. Money market spreads to the euro area have been decreasing from rather high levels since 2001 and have remained relatively stable at around ½ percentage points since 2003. Long-term interest rates in Lithuania stood at around 10 percent in the beginning of 2001 but declined considerably toward euro area levels in the course of 2001 and 2002, in line with muted inflationary pressures and strong gains in policy credibility. In August 2004, Lithuania's long-term interest rate spread vis-à-vis the euro area stood at 0.4 percentage points.

In *Hungary*, developments in long-term interest rates have diverged from euro area developments in the recent past and long-term interest rates currently stand well above the euro area average. Both key policy rates and long-term bond yields have remained significantly above the level of the euro area for most of the period since 1999. The disinflation process, accompanied by successively decreasing policy rates, came to a halt in 2003 and turbulence in the forint market with associated capital outflows in mid-2003 triggered substantial increases in the key policy rate in the second half of that year. Reflecting the overall improvement in the outlook in Hungary until mid-2003, long-term interest rates declined by more than 2 percentage points between the beginning of 2001 and their trough in May-June 2003. Since then, long-term interest rates have risen considerably to similar

73 Due to its sound public finance position, Estonia has very limited government debt; no harmonised 10-year government bond in kroon or comparable security in line with the common statistical framework could be identified. At this stage, an indicator is derived from bank lending rates: the weighted average interest rate on the monthly EEK-denominated new business loans issued to resident non-financial corporations and households, with an original maturity over 5 years (see Box 6.1).

levels as in early 2001 and remained in August 2004 more than 4 percentage points above the euro area average. The rise in long-term interest rates appears to have been associated mainly with an increase in foreign exchange risk premia and higher inflation expectations.

At the beginning of 2001, *Malta* had the lowest long-term interest rate among the new Member States and the decline towards euro area yield levels has continued. Against the background of low inflationary pressures, monetary policy was eased significantly in the period until mid-2003; since then, monetary policy rates have been left on hold. Long-term interest rate spreads vis-à-vis the euro area stood in August 2004 at 0.6 percentage points in Malta.

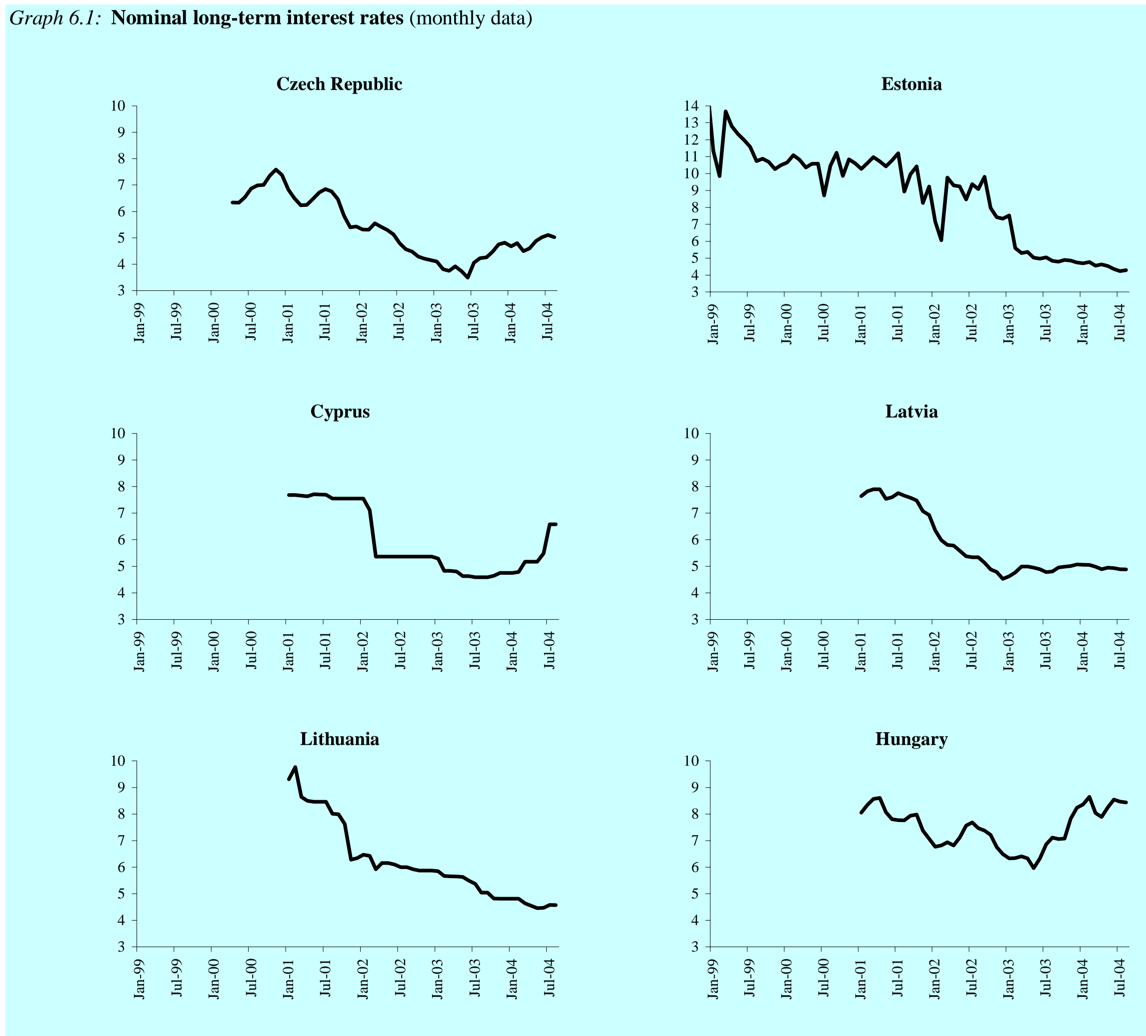
In *Poland*, long-term interest rates currently stand well above the euro area average, partly due to increasing uncertainties about the economic policy outlook. The sustained disinflation process over the past years allowed the central bank to lower policy rates substantially until mid-2003, but the subsequent shift in the balance of risks to inflation ended the easing cycle and the key policy rate has been raised on several occasions since June 2004. The overall improvement in the outlook in Poland until mid-2003 was reflected in a decline in the long-term interest rate by 5 percentage points between the beginning of 2001 and the trough in May-June 2003. Since then, long-term interest rates have risen and remained in August 2004 more than 3 percentage points above the euro area average, reflecting concerns about fiscal policies and their impact on inflation as well as the exchange rate outlook.

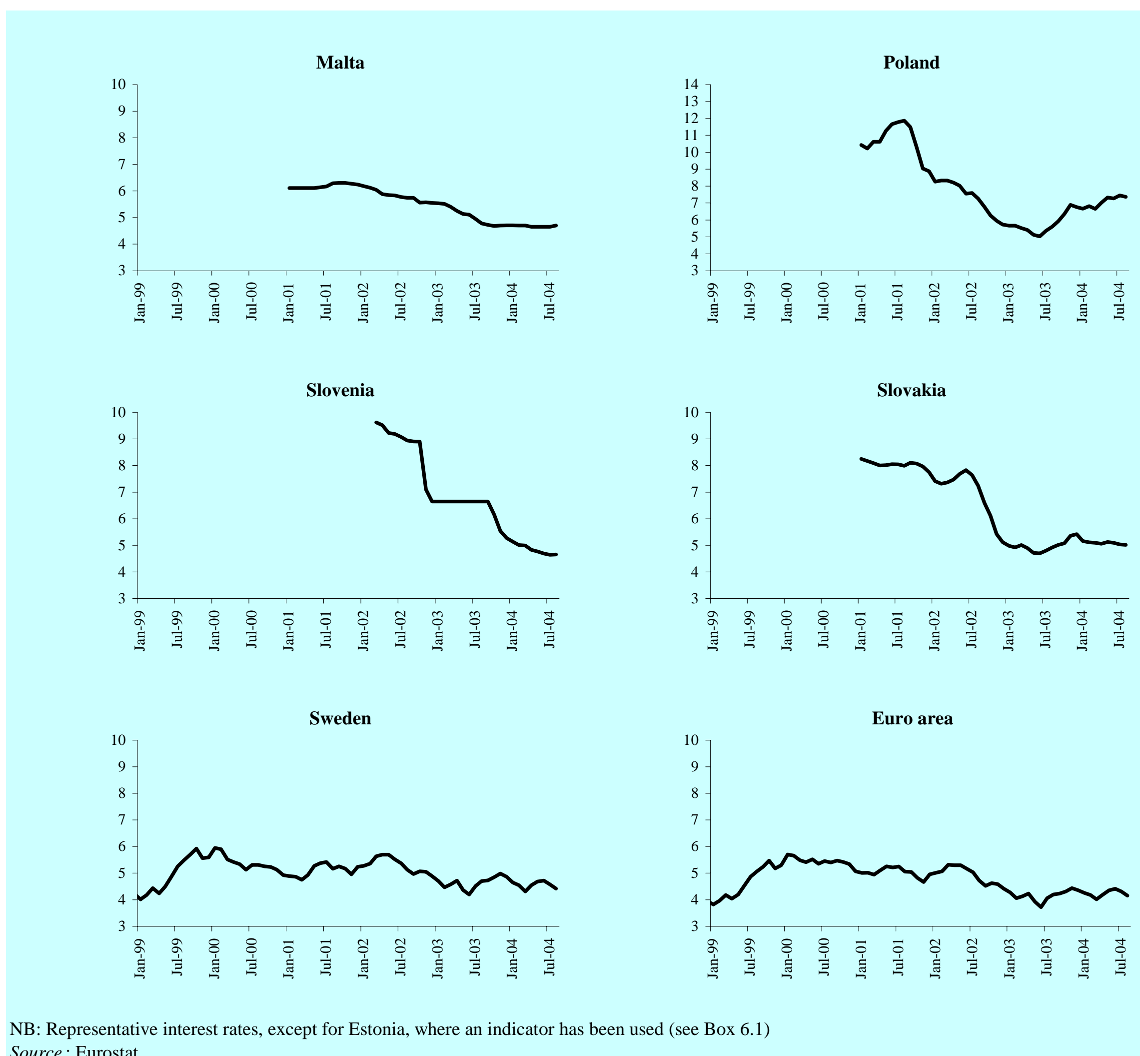
Inflation in *Slovenia* has gradually fallen since 2001, allowing the central bank to lower key policy rates. The long-term interest rate was still quite high in mid-2002 but has declined sharply toward the euro area level since then. The long-term interest rate differential vis-à-vis the euro area stood in August 2004 at around 0.5 percentage points.

In *Slovakia*, the relatively high level of headline inflation has not prevented the central bank from gradually lowering policy rates since the second half of 2002, mainly to ward off currency appreciation pressures. The long-term interest rate declined considerably towards euro area levels in the second half of 2002, partly associated with the disappearance of political uncertainties linked to the parliamentary elections. The long-term interest rate spread vis-à-vis the euro area stood at 0.9 percentage points in August 2004.

Sweden has consistently been in the group of countries with the lowest long-term interest rates among the Member States with a derogation, reflecting a high degree of macroeconomic stability and a credible economic policy framework. Notwithstanding some periods of negative interest rate differentials, Sweden's long-term interest rate has generally been fluctuating within 0.5 percentage points above the euro area long-term rate since 1999. In August 2004, the long-term interest rate differential vis-à-vis the euro area was 0.3 percentage points.

Graph 6.1: **Nominal long-term interest rates** (monthly data)





NB: Representative interest rates, except for Estonia, where an indicator has been used (see Box 6.1)
Source : Eurostat

6.3. Assessment of long-term interest rate convergence in terms of the Treaty criterion

For the assessment of the criterion on the convergence of interest rates, yields on benchmark 10-year bonds have been used; details about the interest rates used for the Member States are given in Box 6.1. The long-term interest rates are averaged over periods of 12 months.

The reference value is calculated from the simple average of the average long-term interest rates of the three best-performing Member States in terms of price stability plus 2 percentage points[74]. As explained in Chapter 3, the three best-performing Member States in terms of price stability are selected using the harmonised indices of consumer prices. Interest rate data for convergence assessment purposes are available only from 2001 for most new Member States, implying that a 12-month average can be computed from December 2001 onward. For the Czech Republic, the required monthly data are available from April 2000, while for Slovenia the series starts only from March 2002. Given the absence of benchmark long-term government bond yields in Estonia, bank lending rates

74 It should be noted that the best-performing Member States in terms of price stability do not necessarily have the lowest interest rates.

Box 6.1: Data for the interest rate convergence criterion

The fourth indent of Article 121(l) of the Treaty requires that the durability of nominal convergence and exchange rate stability in Member States should be assessed by reference to long-term interest rates. Article 4 of the Protocol on the convergence criteria adds that these "*Interest rates shall be measured on the basis of long-term government bonds or comparable securities, taking into account differences in national definitions*".

Article 5 of the Protocol requires that the Commission should provide the statistical data used for the application of the convergence criteria. However, in the context of the interest rate criterion, the European Monetary Institute developed the criteria for harmonising the series of yields on benchmark 10-year bonds on behalf of Eurostat and started collecting the data from the central banks, a task which has then been transferred to the European Central Bank. The selection of bonds for inclusion in this series is based on the following criteria:

- a residual maturity close to 10 years;
- issued by central government;
- adequate liquidity, which is the main selection criterion; the choice between a single benchmark or the simple average of a sample is based on this requirement;
- yield gross of tax;
- fixed coupon.

For all Member States, except Estonia and Luxembourg, the representative interest rates used in this report incorporate all of the above characteristics[75]. Twenty Member States have been using a single benchmark bond and three a sample of bonds (Germany, Spain, and Malta). Out of the nine new Member States, seven yields are calculated on the basis of secondary market yields whereas Cyprus and Lithuania use primary market rates[76].

For Estonia, no appropriate harmonised series or proxy could be identified. Instead, an indicator has been selected: the interest rate on the monthly EEK-denominated loans issued to non-financial corporations and households, with an original maturity over five years. This indicator will be replaced as soon as a more comparable instrument is available.

It has been necessary to identify a proxy for Luxembourg as the remaining maturity of the 10-year bond previously used is now about 3 years. The indicator for Luxembourg is based on a basket of securities, which have together an average residual maturity close to 10 years. The securities are issued by a private bank and have a solid credit rating. This indicator will be replaced as soon as a more comparable instrument becomes available.

75 For Latvia, data prior to February 2003 refer to 5-year government bonds. For Lithuania, data for the period March 2001 to March 2002 refer to 7-year government bonds; data prior to March 2001 refer to 3-year government bonds. For Slovenia, data prior to November 2002 refer to 3-year government bonds.

76 The data for Slovenia for the period November 2002-October 2003 are based on primary market rates.

are used as an indicator on which to base a qualitative assessment of the fulfilment of the long-term interest rate criterion.

Average long-term interest rates for the 12-month period from September 2003 to August 2004 are shown in the final column of Table 6.1. The reference value in August 2004 (derived from the average interest rates in Finland, Denmark and Sweden, the three best-performing Member States in terms of price stability)[77] was 6.4 percent. Average long-term interest rates in eight of the ten Member States for which long-term interest data are available stood below the reference value in July 2004 (all except Hungary and Poland). Therefore, the Czech Republic, Cyprus, Latvia, Lithuania, Malta, Slovenia, Slovakia and Sweden fulfil the criterion on the convergence of long-term interest rates.

The convergence criterion on long-term interest rates is not directly applicable to Estonia. The absence of government long-term benchmark bonds in Estonia reflects a very low level of government debt and prudent fiscal policies, rather than low credibility with markets (which would prevent the sovereign debtor from raising long-term funds). Therefore, it does not preclude Estonia from fulfilling the long-term interest criterion. The 12-month average of bank lending rates in Estonia – which serves as the closest available substitute on which to base a qualitative judgement – has shown a marked decline from 10 percent in December 2001, standing below 5 percent since February 2004. The low level of lending rates suggests contained inflationary expectations, but it does by definition not indicate a market view on fiscal prospects, while reflecting other factors such as private sector credit risk and the degree of competition in the banking sector. It would therefore not be appropriate to assess this substitute indicator directly against the reference value. However, the development of bank lending rates does not suggest any strains that would indicate a lack of market confidence in macroeconomic stability comparable to the situation of countries whose long-term interest rates are above the reference value. For the purposes of this examination, there are no reasons to conclude that Estonia would not fulfil the long-term interest criterion.

The reference value of the long-term interest rate criterion has remained relatively stable at some 6.9 percent for most of 2002, followed by a steady decline to around 6.1 percent in autumn 2003 and a stabilisation at that level since then, followed by a slight increase since May 2004 (see Graph 6.2).

As well as the general downward trend in long-term interest rates, changes in the constituents of the three best-performing Member States in terms of price stability also affected the reference value and caused shifts in its level. The inclusion of the new Member States into the calculation base in May 2004 (with the Czech Republic as one of the three best performers in terms of price stability) led to an upward shift in the reference value of 0.11 percentage points. The long-term interest rate underlying the calculation of the reference value was 0.17 percentage points higher than the euro area average in August 2004.

Three of the Member States under review (the Czech Republic, Malta and Sweden) have had average long-term interest rates below the reference value ever since December 2001, which represents an additional indicator of sustainability. Cyprus, Latvia and Lithuania have had average long-term interest rates below the reference value since spring 2002, while Slovakia's average long-term interest rate fell below the reference value in January 2003. Slovenia experienced a late but pronounced convergence in the average long-term interest rate; from the beginning of its data series in February 2003 to October 2003, it had the highest 12-month average long-term interest rate among the new Member States, declining but still well above the reference value. Following a further significant reduction in yield spreads, Slovenia's average long-term interest rate fell below the reference value in March 2004. Poland's average long-term interest rate, which had stood below the reference value between April 2003 and March 2004, exceeded the reference value again in the period April to August 2004; the margin was slightly less than 0.5 percentage points in August 2004. Hungary's long-term interest rate has always exceeded the reference value; while the distance to the reference value had been below 0.5 percentage points between April 2002 and October 2003 (coming as close as 0.2 percentage points in late 2002), it has widened considerably since then, standing at 1.6 percentage points in August 2004.

77 See Chapter 3.

Table 6.1
Development of long-term interest rates

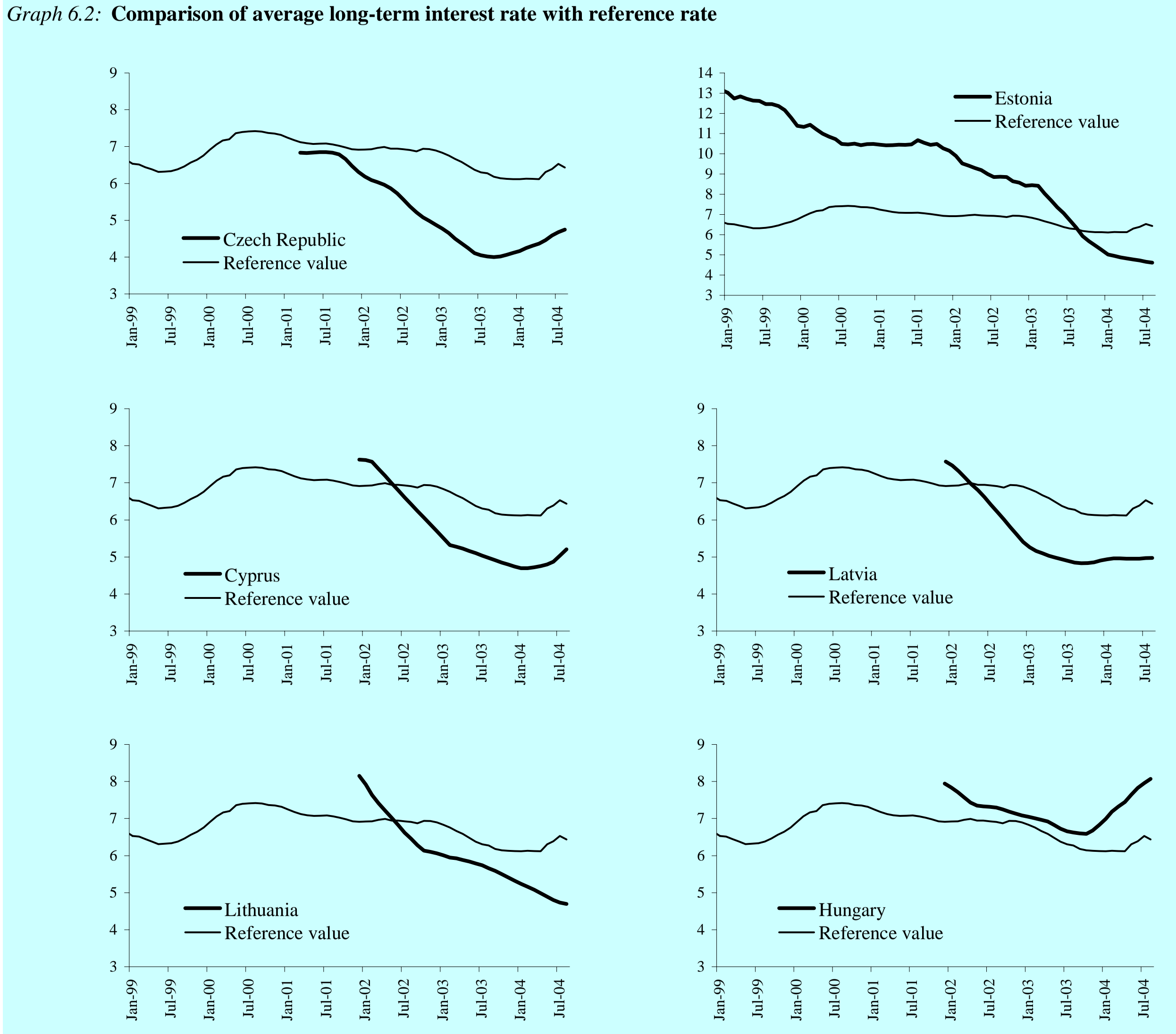
(12 month averages)

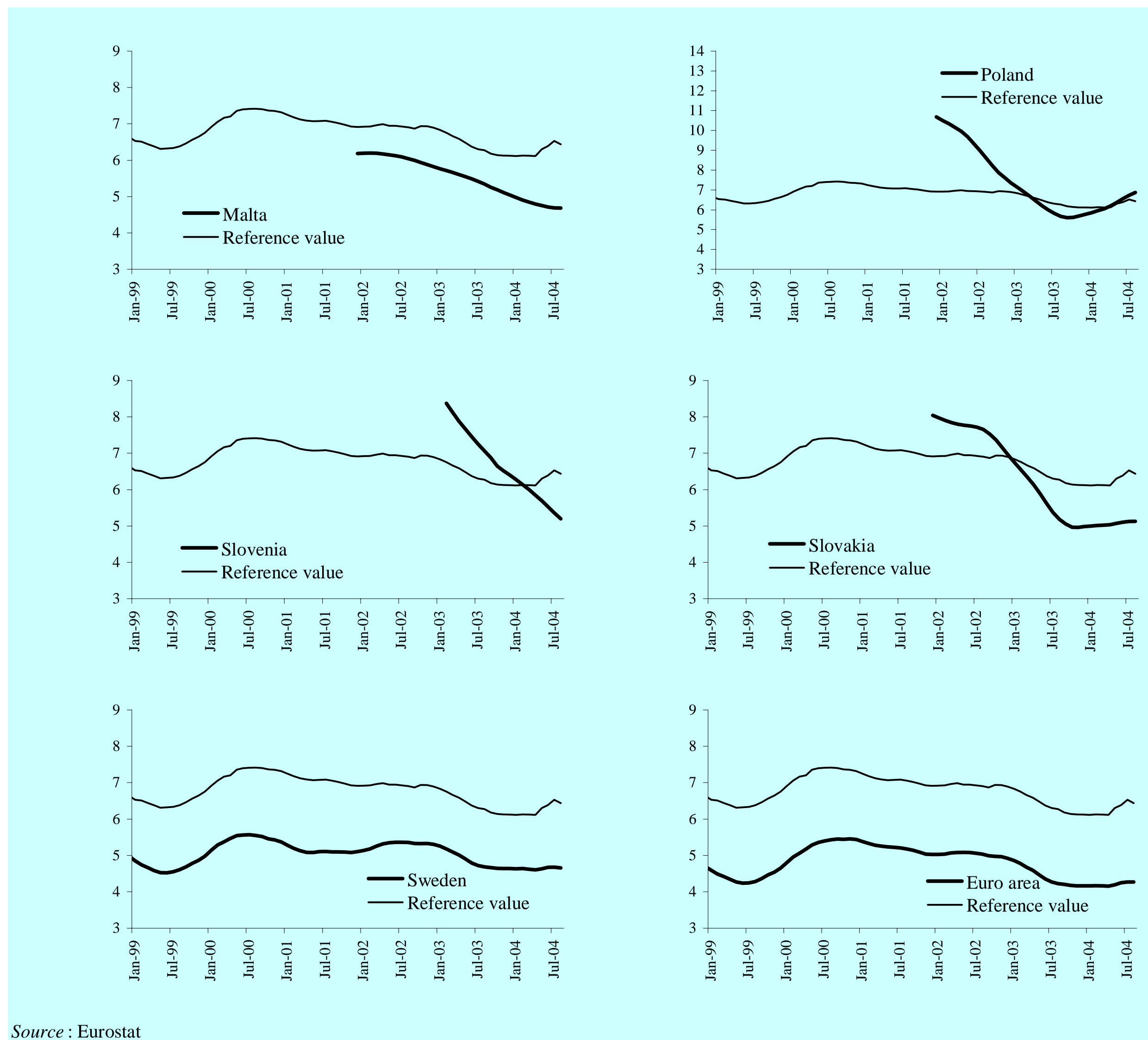
	1998	1999	2000	2001	2002	2003	Aug-2004[1]
CZ	--	--	--	6.3	4.9	4.1	4.7
EE[2]	13.2	11.4	10.5	10.2	8.4	5.2	4.6
CY	--	--	--	7.6	5.7	4.7	5.2
LV	--	--	--	7.6	5.4	4.9	5.0
LT	--	--	--	8.2	6.1	5.3	4.7
HU	--	--	--	7.9	7.1	6.8	8.1
MT	--	--	--	6.2	5.8	5.0	4.7
PL	--	--	--	10.7	7.4	5.8	6.9
SI	--	--	--	--	--	6.4	5.2
SK	--	--	--	8.0	6.9	5.0	5.1
SE	5.0	5.0	5.4	5.1	5.3	4.6	4.7
Euro area	4.7	4.7	5.4	5.0	4.9	4.2	4.3
Reference value[3]	6.6	6.8	7.3	6.9	6.9	6.1	6.4

[1] Average Sep-03 to Aug-04
[2] Bank lending rates; not directly comparable with long-term interest rate data for the other Member States
[3] Average of interest rates of the three best-performing Member States in terms of price stability plus 2 percentage points (in Aug-04: FI 4.23;DK 4.42; SE 4.66)

Source : Eurostat

Graph 6.2: **Comparison of average long-term interest rate with reference rate**





Source : Eurostat

7. ADDITIONAL FACTORS

This chapter examines two areas associated with economic integration and convergence, which Article 121 stipulates also need to be taken into account in the report:

– the results of the integration of markets and

– the situation and development of the current account of the balance of payments.

The requirement in the Treaty reflects the need to ensure that the Member States that will join the euro area exhibit a satisfactory degree of financial and product market integration with the EU and have sustainable current account positions. The following sections examine the results of market integration separately for financial markets and product markets and then the situation and development of the current account of the balance of payments. The examination of the development of unit labour costs and other price indices, which is also prescribed by Article 121, is taken up in the chapter dealing with price stability (Chapter 3)[78].

7.1. Results of the integration of markets

7.1.1. Financial market integration

An efficient financial system is a prerequisite for sustainable economic growth and development, and will be an important driver of the catching-up process in the Member States that have recently joined the Union. Quantifying the benefits of a more integrated EU financial system is difficult, but recent studies undertaken on behalf of the Commission suggest that the impact of financial integration on the performance of the EU economy will be substantially positive and durable[79]. Efforts to enhance the functioning of the EU financial system have intensified markedly since the introduction of the euro in 1999 and Sweden has participated fully in these efforts.

While the process of EU financial integration can be expected to accelerate in the coming years, progress in bringing the financial systems of the new Member States into line with existing EU requirements is already well advanced. The adoption of the *acquis communautaire* and expectations of future adoption of the euro have fostered convergence in all financial-market segments. Moreover, the involvement of strategic foreign investors in developing the financial systems of the new Member States ahead of accession has resulted in the unusual situation that their banking systems are generally more integrated with the rest of the EU than the banking systems of the euro area Member States. Reflecting this relatively advanced state of integration, the euro is already playing a significant role as a financing and investment currency in most of the new Member States.

This section of the report examines the degree of financial integration achieved between Sweden, the new Member States and the euro area, focusing on the main characteristics, structures and trends in their financial systems. Empirical analysis of financial integration relies on the use of relevant financial indicators, with the typical drawbacks in relation to the availability and comparability of data[80]. Moreover, it should be borne in mind that comparison with euro area indicators can provide false impressions of the degree of convergence/integration achieved, as euro area averages often hide significant variations between the participating Member States. The analysis begins by briefly reviewing the compliance of Sweden and the

78 Article 121, reflecting the situation before the beginning of the third stage of EMU, prescribed that the report should also take into account the development of the ecu. The provision can be considered obsolete following the irrevocable fixing of the parities between the participating national currencies and the ecu and the converting of the ecu at one-to-one with the euro at the start of Stage III on 1 January 1999. The section on financial market integration provides information on the use of the euro in the Member States covered by the report.

79 See: London Economics (2002) Quantification of the Macro-Economic Impact of Integration of EU Financial Markets and Giannetti M., L.Guiso, T. Jappelli, M. Padula and M. Pagano (2002), "Financial market Integration, Corporate Financing and Growth", DG ECFIN Economic Paper N° 179.

80 Indeed, even the definition of an integrated financial market remains uncertain. A recent definition (see Lieven Baele, Annalisa Ferrando, Peter Hördahl, Elizaveta Krylova and Cyril Monnet: Measuring financial integration in the euro area, ECB Occasional Paper No. 14, April 2004) suggests that integration is achieved when all economic agents face identical rules and have equal access to financial instruments or services. This definition conforms to the objectives of the *acquis communautaire* in providing a common legal and regulatory framework for the EU market as a whole, but does not provide the basis for assessing the extent of financial integration in practice.

new Member States with EU financial legislation under the *acquis*. Following a synthetic overview of the various national financial systems, the degree of integration achieved with the euro area is assessed by reference to various financial market segments, with a particular focus on the use of the euro.

7.1.1.1. Compliance with EU financial legislation

Compliance with the *acquis communautaire* (i.e. the implementation and enforcement of existing EU legislation) in respect of the financial sector is a moving target for all of the Member States. However, the current level of compliance for Sweden and the new Member States in the area of financial services is generally favourable. Sweden adopted the *acquis* in relation to the financial sector on its accession in 1995 and has participated in the formulation, adoption and now transposition of the new legislation contained in the Financial Services Action Plan[81].

The new Member States made substantial progress toward compliance with the *acquis* (including the FSAP measures) in preparation for their accession to the Union in 2004[82]. Practically full compliance has been achieved in respect of the free movement of capital (Chapter 4) and company law (Chapter 5). Some of the new Member States have retained specific transitional arrangements in relation to the freedom to provide financial services (Chapter 3), e.g. in the area of accounting rules, capital requirements for co-operative and saving banks, the minimum level of deposit guarantees and investor compensation schemes. With regard to taxation (Chapter 10), a limited number of derogations in the field of VAT and excise have been negotiated for all of the new Member States. Finally, all of the new Member States will need to make additional efforts toward compliance with the *acquis* in the field of consumer protection (Chapter 23). The state of compliance with the *acquis* in the new Member States is summarised in Table 7.1.

81 To this end, the Financial Services Action Plan (FSAP) – comprising 42 legislative and non-legislative actions and covering a wide range of financial market segments - was adopted in 1999 and should be fully implemented by the end of 2005.

82 See European Financial Services Regulation (EFSR), May 04; Comprehensive monitoring report of the European Commission on the state of preparedness for EU membership of the Czech Republic, Estonia, Cyprus, Latvia, Lithuania, Hungary, Malta, Poland, Slovenia and Slovakia, available at http://europa.eu.int/comm/enlargement/report_2003/pdf/summary_paper2003_full_en.pdf.

Table 7.1
New Member States' state of adoption of financial market related *acquis* upon EU entry

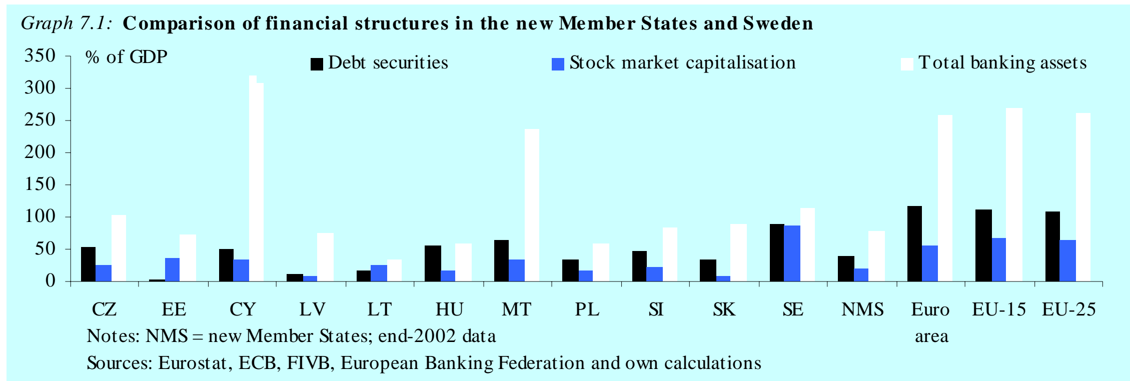
Negotiation Chapters	State of the adoption upon EU entry
Chapter 3 on the freedom to provide services	Transitional arrangements in the area of accounting rules or capital requirements for co-operative and saving banks (e.g. in Cyprus, Hungary, Poland and Slovenia) and the minimum level of deposit guarantee schemes (e.g. the Baltic States and Slovenia) or investor compensation schemes (e.g. for the Baltic States, Hungary, Poland, Slovenia and Slovakia)
Chapter 4 on free movement of capital	No major discrepancies
Chapter 5 on company law	No major discrepancies
Chapter 10 on taxation	Limited number of derogations in the filed of VAT and excise duties requested by all new Member States
Chapter 11 on EMU	Derogation until adoption of the euro after compliance with Maastricht criteria
Chapter 23 on consumer protection	More efforts to grant consumer rights, to ensure free competition and circulation of goods requested

Source : Commission services

7.1.1.2. Financial structure and characteristics

Reflecting their different political and economic evolution, Sweden and the new Member States have financial systems which vary significantly in terms of development and structure. Sweden has the most developed of the national financial systems under review, followed by Cyprus and Malta and then by the remaining new Member States. Accordingly, their financial systems also vary in terms of integration with the euro area financial system. While divergence in financial structure is not *per se* indicative of a lack of financial integration (e.g. in an integrated EU financial market, there could be an incentive for greater specialisation at the Member State level), it is to be expected that progress in financial development – particularly in the new Member States – will result in a progressive convergence with the overall financial structure of the euro area. The extent of convergence so far can be assessed on the basis of Graph 7.1, which provides data on the financial structure in the eleven Member States under review as well as averages for the new Member States and for the EU.

Despite its overall high level of financial development, Sweden has a low degree of financial intermediation compared to the euro area as a whole. Relative to GDP, the total assets of the banking sector, bank loans and bank deposits are all about half the euro area average and are below the levels in most of the euro area Member States. On the other hand, Sweden’s capital markets are well developed both in size and sophistication (e.g. in terms of liquidity of instruments, use of derivatives and participation of foreign investors) relative to most of the euro area Member States.



Graph 7.1: **Comparison of financial structures in the new Member States and Sweden**

Notes: NMS = new Member States; end-2002 data

Sources: Eurostat, ECB, FIVB, European Banking Federation and own calculations

In the eight new Member States of Central and Eastern Europe, the level of financial intermediation remains low when compared to the euro area average. Relative to GDP, total assets of the banking sector, total loans and total deposits are well below the euro area average and, indeed, are below those in any of the euro area Member States. These new Member States have established domestic markets for money, bonds and equities, but these are small in both absolute terms and relative to GDP with a generally limited number of issuers and secondary market activity. In this respect also, their capital markets are relatively underdeveloped when compared to the euro area average and most of the individual euro area Member States. In contrast, Cyprus and Malta – both of which are established market economies with off-shore financial centres – have banking systems that are comparable to the euro area banking system in terms of GDP, but their capital markets are also comparably small and illiquid.

7.1.1.3. Progress in financial integration

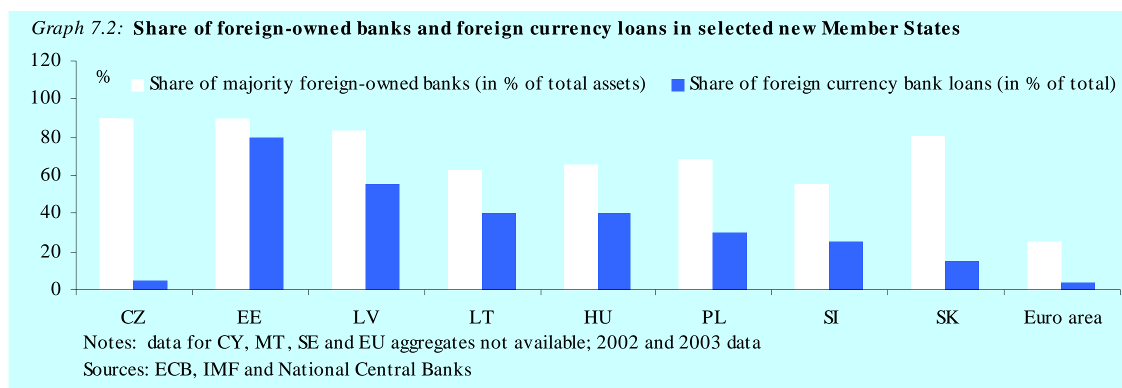
7.1.1.3.1 Financial intermediaries

Banking sector

In Sweden, the banking system has become more concentrated over time and is characterised by a high degree of integration within the Nordic region – although Finland is the only euro area Member State involved.

The Nordic banking sector is dominated by four Swedish banks – Handelsbanken, SEB, Nordea Bank Sverige and Föreningssparbaken – which account for a total of 85 percent of the region's banking sector assets[83]. Integration within the banking system is set to intensify in the near term, with the decision by Nordea to establish as a single entity under the European Company Statute. In practical terms, this will mean that Nordea will transform from a subsidiary-based to a branch-based bank, which will have important implications for the functional organisation of the bank as well as for cross-border supervisory arrangements. Mortgage banks play a relatively important role in the Swedish banking system, holding about one third of the system's total assets.

83 Sveriges Riksbank , "The Swedish Financial Market 2003", available at www.riksbank.se.



Graph 7.2: **Share of foreign-owned banks and foreign currency loans in selected new Member States**

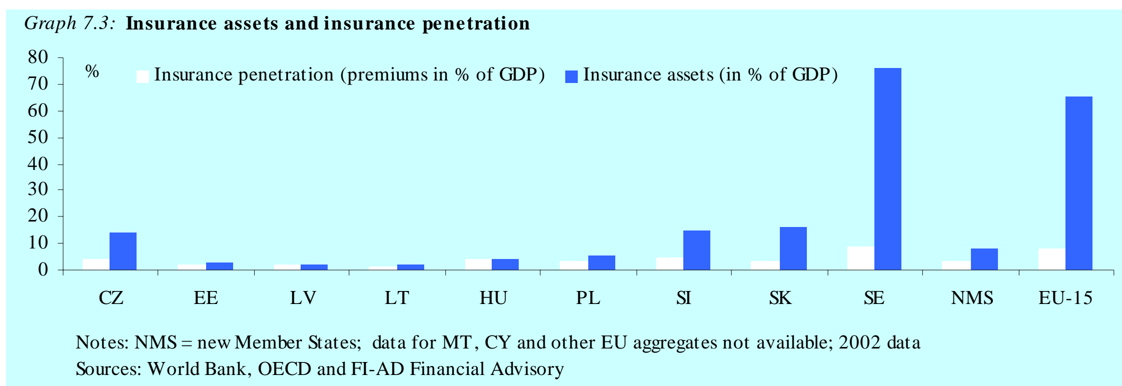
Notes: data for CY, MT, SE and EU aggregates not available; 2002 and 2003 data
Sources: ECB, IMF and National Central Banks

The banking systems of the new Member States – particularly those of Central and Eastern Europe – are characterised by high degrees of foreign ownership, mainly originating in other EU Member States including those in the euro area. Foreign ownership of financial intermediaries is, in principle, a powerful driving force for financial integration. Although foreign ownership does not automatically imply convergence in financing systems across countries, the interaction of scale/scope economies and enhanced competition should ensure that the nature of financial products and services provided in the new Member States will converge with those provided elsewhere in the EU. While their strategies have varied, almost all of the new Member States have encouraged the involvement of strategic foreign investors in the privatisation and consolidation of their banking systems; this followed an initial phase of rapid expansion, poor supervision and macroeconomic instability, which in many cases resulted in severe financial crisis. Attracted by high margins and future growth prospects in the new Member States, foreign investment has helped to re-capitalise the banking systems of the new Member States concerned, while transferring important expertise and technology[84]. Foreign ownership has ensured that the new Member States' banking systems are now largely well capitalised, solvent and profitable, even if the share of non-performing loans remains higher than in other EU countries. Given the importance of banking as a component of the financial systems of the new Member States, this high degree of foreign ownership should be a major asset in sustaining a process of nominal and real convergence with the euro area.

Facilitated by cross-ownership with euro area Member States, the share of euro-denominated bank loans and deposits in the new Member States is generally quite high. The share of foreign currency lending – mainly in euro – is notable in Estonia, Latvia, Lithuania and Hungary. Only in the Czech Republic can the share of foreign currency loans in total be described as low. In some of the new Member States, foreign currency borrowing by the corporate and household sectors is substantially un-hedged, creating an exposure to the risk of an unanticipated devaluation in the domestic currency. On the deposit side, offshore activities are reflected in substantial foreign currency deposits in Latvia, Cyprus and Malta. In the latter two new Member States, the activities of foreign-owned banks have been traditionally focussed on offshore activities, but some of these institutions have also begun to offer services in the domestic markets following the abolition of legal barriers. As a counterpart of business expansion

84 Slovenia is now the only new Member State in Central and Eastern Europe in which foreign-owned banks account for less than half of total assets and capital. The share of foreign-owned banks is very high (i.e. about 80 percent or more of total assets or capital) in Estonia, Lithuania, the Czech Republic, Slovakia and Hungary, and quite high in Latvia and Poland. Public banks have retained a significant share of the market only in Poland and Slovenia (with a share of about 25 percent of total assets). The presence of European and US banks in the new Member States is mostly in the form of subsidiaries or majority shareholders of listed domestic banks, with the main foreign investors coming from Austria (e.g. Bank Austria/Creditanstalt, Erste Bank, Raiffeisen), Belgium (e.g. KBC), Italy (e.g. Unicredito, Banca Commerciale Italiana/Intesa), France (e.g. Société Générale), the Netherlands (e.g. ING), Germany (e.g. Commerzbank) and the United States (e.g. Citibank) while Swedish and Finnish banks (SEB, Nordea) are particularly active in the Baltic States.

Graph 7.3: **Insurance assets and insurance penetration**



Notes: NMS = new Member States; data for MT, CY and other EU aggregates not available; 2002 data
Sources: World Bank, OECD and FI-AD Financial Advisory

to other countries – notably the Baltic States – the Swedish banking system's lending to foreign banks and public has increased, accounting for about 20 percent of total lending.

Insurance sector

The Swedish insurance sector is large (with an insurance penetration at par with EU-15 and euro area levels). While many small local companies participate in the market, it is dominated by a small number of larger players. The insurance sector is expanding rapidly in the new Member States, but remains underdeveloped relative to the euro area as a whole. For instance, insurance penetration (i.e. premiums as a percentage of GDP) tends to be less than half of the euro area average, while the life insurance sector is still particularly underdeveloped despite a recent pick-up in growth. The Czech Republic and Slovenia have the most developed insurance sectors, while the low level of development of insurance in the Baltic States reflects the small size of their population (which has hindered growth and dissuaded foreign investment in the sector).

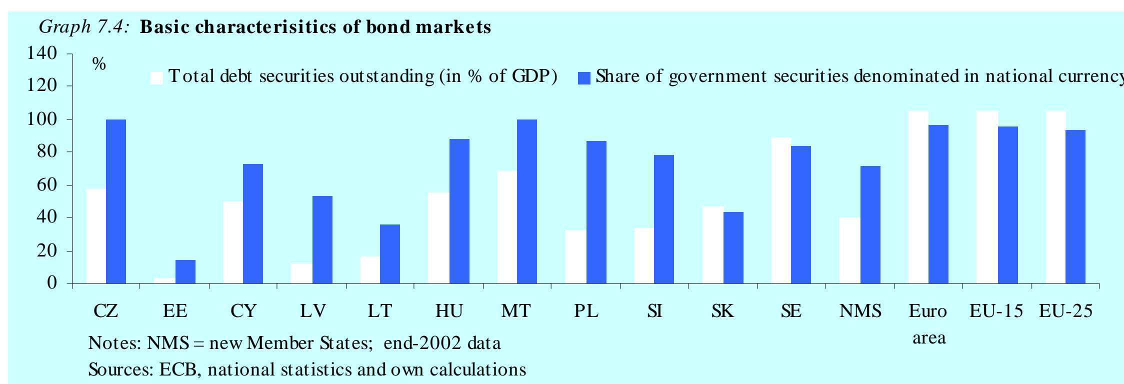
However, the insurance sector in the new Member States is expected to grow rapidly over the coming years, driven by increasing per capita income and ageing of the population. Several large insurance companies from EU-15 countries have recently expanded into new Member States' markets, and the Czech, Estonian, Slovak and Hungarian insurance sectors are almost entirely controlled by foreign insurers. The Cypriot insurance sector also has a substantial number of foreign participants. On the other hand, the largest insurance companies in Poland and Slovenia are owned in the main by local investors, while two large domestic banks dominate Malta's small insurance sector.

Pension funds

In Sweden, assets under management by private pension funds remain small (some 3 percent of GDP), but the state-owned pension funds sector is large (about 20 percent of GDP in terms of assets under management). Similarly, the scale of public pension systems in both Malta and Cyprus has left little room for the development of private occupational funds. Pension funds are developing quickly in most of the new Member States, although the level of pension fund assets in terms of GDP is still generally below the euro area average[85]. Pension funds are expected to become important financial intermediaries in the new Member States, amid reforms to domestic pension schemes. As the growth in pension funds' assets under management accelerates, it is unclear whether domestic securities markets will be able to respond to such growth and there may be a need for increased investment in foreign assets. Pension funds in several new Member States have already invested substantially in foreign assets[86]. In these circumstances, increased investment in euro area assets is to be expected – particularly in countries with a peg to the euro or participating in ERM II – subject to any prudential restrictions.

85 The level of pension fund assets relative to GDP in the new Member States ranges from 0 percent in Lithuania to 5.2 percent in Hungary, with an average of 3.5 percent. This compares to an average of about 30 percent for the EU-15 and a high of 90 percent in the Netherlands and the United Kingdom.

86 For example, 50 percent of pension funds are invested in foreign assets in Estonia, 12 percent in Latvia, although the ratio is less than 2 percent in Poland where restrictions are applied for prudential reasons.



Graph 7.4: **Basic characterisitics of bond markets**

Notes: NMS = new Member States; end-2002 data
Sources: ECB, national statistics and own calculations

Mutual funds

The Swedish mutual funds industry is large and diverse. In the new Member States, the assets of mutual funds relative to GDP remain below EU-15 and euro area levels, but the industry is expected to grow – albeit not as rapidly as the pension funds industry – in the coming years. Mutual funds may also suffer from a domestic asset constraint due to the undeveloped state of domestic capital markets and an increase in euro area investments would again be expected – subject to any prudential restrictions.

Supervisory arrangements

With progress in financial integration and the resulting inter-linkage of national financial systems, adequate supervision of financial institutions becomes a crucial element in safeguarding stability. Although the new Member States have significantly strengthened their financial supervisory arrangements in recent years, the growth and structural changes within their financial systems pose new challenges. The expansion in non-banking intermediation calls for a further strengthening of insurance supervision and cross-sector cooperation among supervisors. In addition, the high level of foreign ownership in the financial systems of the new Member States and a typically high degree of market concentration calls for a further strengthening in cross-border cooperation in financial supervision.

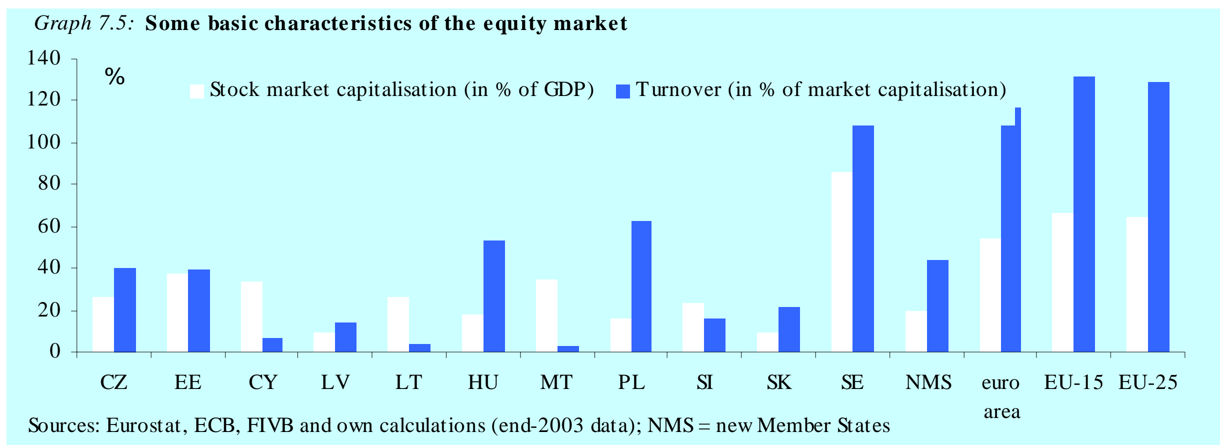
7.1.1.3.2 Capital markets

Fixed income markets

Sweden's fixed-income securities markets are comparably well-developed and internationally integrated, although they remain substantially less liquid than the corresponding euro-denominated markets. The Swedish debt market is among the smaller of the EU debt markets, but its size relative to GDP (89 percent) is close to the average for EU-15 (111 percent) and euro area (115 percent). Central government and mortgage institutions issuers account for about 50 percent and 40 percent of total issuance respectively, leaving only a small share to other issuers such as municipalities and corporations. Fixed income markets in the new Member States are generally small and illiquid. In terms of total amounts of securities outstanding at the end of 2002, the new Member States account for only 2 percent of the EU-25 markets. Only the three biggest markets in the new Member States, i.e. Poland, the Czech Republic and Hungary, are larger than the Irish market, which is currently the smallest in the euro area. On the other hand, the size of markets in the new Member States in terms of GDP is generally closer to the euro area average. A common feature of fixed-income markets in the new Member States is the dominance of central government issuance, which accounts for a share of between 80 percent and 100 percent in most cases. Issuance by the private sector represents a significant share of total only in the Czech Republic, Slovenia and Estonia.

Expectations of future euro adoption have become a main driver of bond yields in the new Member States and yields have already converged significantly toward euro area levels. Expectations of euro adoption may also explain the share of the euro in issuance by the new Member States. Malta is the only new Member State not to have issued a euro-denominated bond and the share of euro-denominated debt is very high in some of

Graph 7.5: **Some basic characteristics of the equity market**



Sources: Eurostat, ECB, FIVB and own calculations (end-2003 data); NMS = new Member States

the smaller new Member States – although outstanding debt is still denominated mainly in national currency in the Czech Republic, Cyprus, Hungary, Malta, Poland and Slovakia. Meanwhile, Sweden has about a quarter of its debt in foreign currency and uses foreign exchange derivatives and foreign currency bonds (denominated notably euro and US dollars) to manage its foreign debt exposure.

Equity markets

The Swedish stock market is large and liquid and is integrated with its Nordic counterparts. In contrast, most of the equity markets in the new Member States are small and illiquid. Market capitalisation in terms of GDP is less than half of the euro area level for most of the new Member States and turnover is generally less than one sixth of the euro area level. However, levels of development vary widely among the new Member States. Poland, the Czech Republic and Hungary have the largest markets in absolute terms, while Estonia, Malta and Cyprus have the largest markets in terms of GDP. In the new Member States of Central and Eastern Europe, equity markets were generally shaped by the choice of privatisation method. New Member States using the voucher privatisation method (e.g. the Czech Republic, Lithuania and Slovakia) began with a large number of listed companies, which were gradually de-listed for reasons of illiquidity. New Member States employing a case-by-case approach to privatisation (e.g. Estonia, Hungary, Latvia, Poland and Slovenia) began with a small number of more liquid stocks, but these markets still have few actively traded companies. Stock markets in Malta and Cyprus are also relatively new, small and illiquid.

The liquidity of new Member States' domestic markets has however improved over time, supported by enhanced domestic regulation, relatively strong economic growth, improved corporate profitability, and increasing demand from institutional investors. In addition, a number of successful IPOs were recently recorded (including a foreign company on the Warsaw stock exchange). However, it is fair to say that equity markets in the new Member States have not yet established themselves as effective mechanisms for corporate sector financing. To acquire access to a wider investor base – and to cheaper capital – a significant number of companies in the new Member States have been cross-listing abroad[87], mostly in New York and London and to a much lesser extent within the euro area. Meanwhile, several exchanges of the new Member States have entered strategic partnerships with other exchanges. For instance the Tallinn and Riga exchanges have been integrated into the HEX market alongside the Stockholm and Helsinki stock exchanges[88]. The Warsaw stock exchange has signed a cross-membership and cross-access agreement with Euronext. Stock markets from the new Member States are, therefore, increasingly integrated, via growing portfolio equity flows, as well as functionally. However, this integration is global and not specifically with the euro area.

87 Defined here to include dual-listing as well as listing only on an international exchange.

88 As such, they are now part of the NOREX alliance connecting also the Copenhagen, Iceland and Oslo stock exchanges.

7.1.1.4. Conclusion

Although difficult to measure with accuracy, evidence suggests that financial integration between the Member States under review and the euro area is quite advanced. Foreign ownership in the banking sector is more established in Sweden and the new Member States than in most of the euro area Member States. This high degree of foreign ownership should help the new Member States in sustaining a process of nominal and real convergence toward the euro area, but points to a need for enhanced cross-border cooperation within the current arrangements for financial supervision. Issuance of fixed-income securities in euro is widespread among the new Member States and links with euro area equity markets have been established as part of a process of global integration. In addition, long-term government bond yields have already converged significantly toward euro area levels.

7.1.2. Product market integration

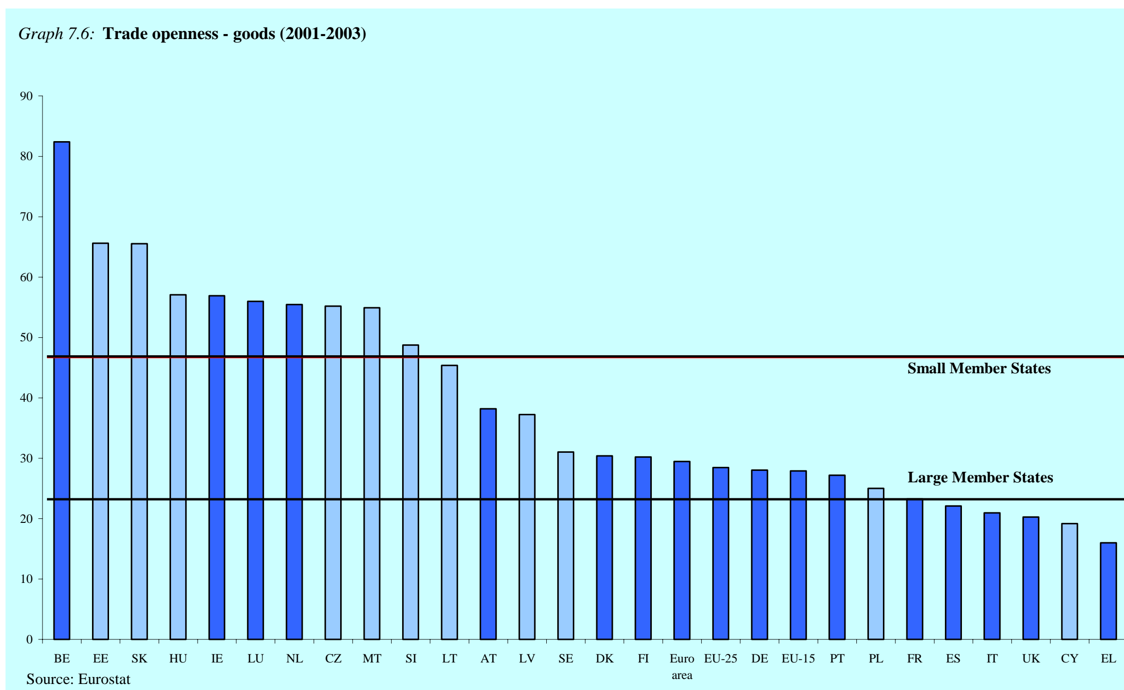
This section presents evidence on the development of product market integration of the ten new Member States and Sweden. The degree of integration of product markets plays an important role in examining real convergence of Member States. Moreover, increasing competition in product markets, which is a result of continuing integration, can help enhance the efficiency of Member States' economies and thus improve their adaptability to asymmetric shocks. Integration of product markets is assessed through trade, FDI and M&A activity and a smooth functioning of the Internal Market. The focus is predominantly on the situation in the new Member States. Given that the degree of product market integration is a slow-moving characteristic and that the situation of Sweden was extensively analysed in the 2002 Convergence Report, the section only provides updates on product market integration in Sweden where necessary.

The new Member States have experienced considerable structural change and convergence towards the EU-15 over the last 15 years. This is due to the transition to fully-fledged market economies in general and to the process of integration with the EU in particular. The intensive trade and investment links with the EU-15 have played an essential role in this respect. Adoption and application of Internal Market *acquis* have created initial conditions for satisfactory integration of the new Member States into the Internal Market although considerable effort is still needed to ensure its smooth functioning in the enlarged EU. Structural reforms have improved the competitiveness of the new Member States' economies and contributed to increasing the level of competition. As documented in the 2002 Convergence Report, Sweden is well integrated in the European economy and this process has continued in the most recent period.

7.1.2.1. Trade and FDI

The new Member States are all open economies. Their trade openness, defined as average imports and exports divided by GDP, is high and most of them trade more intensively than the average small EU countries. The trade openness of Poland, which shares characteristics of large economies, exceeds the average for the other large Member States. Due to its special situation, Cyprus trades relatively little in goods but its openness increases considerably once trade in services is taken into account, because of the large contribution from tourism (see Graph 7.6).

Graph 7.6: **Trade openness - goods (2001-2003)**



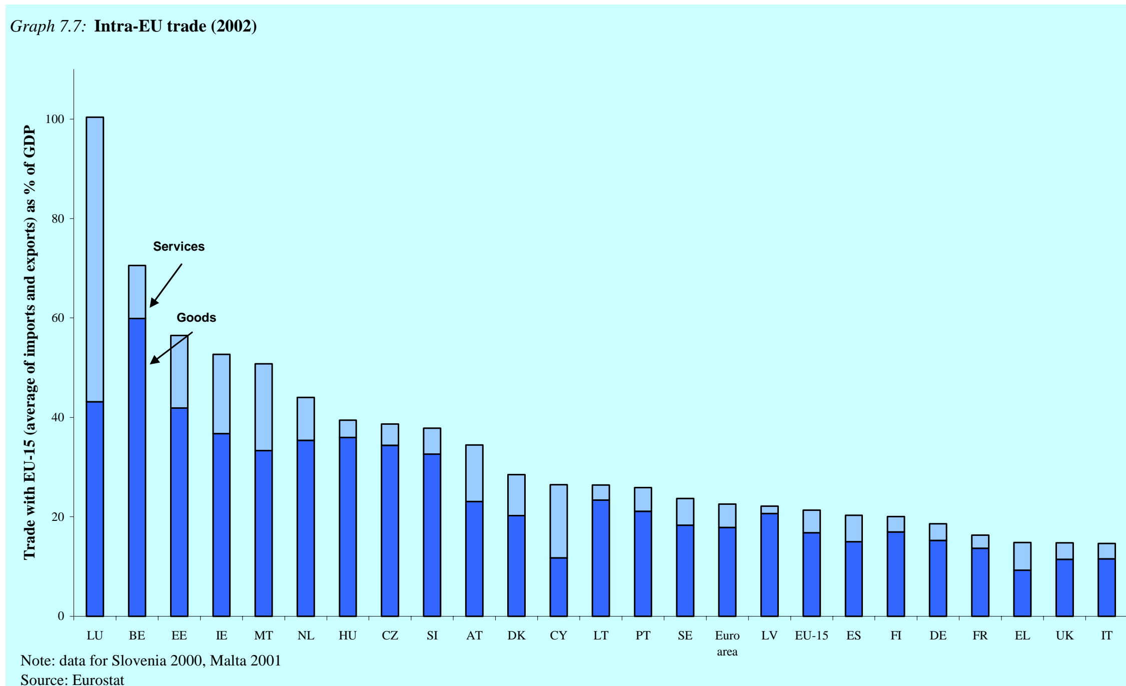
Source: Eurostat

The EU-15 is the major trading partner for most of the new Member States. Trade flows with the EU-15 have been progressively increasing over the last decade as a result of the continuous removal of barriers to trade in the context of integration into the Internal Market and also the general catching-up process of these countries. It can be expected that this link will be further strengthened as a result of EU membership and the related removal of the remaining barriers to trade. The Graph 7.7 indicates that already now many new Member States belong to the best performers in the EU in terms of intra-EU trade (in goods and services) as a share of GDP. The highest potential for increases in intra-EU trade lies within the services sector, as the share of services in intra-EU trade is on average lower in the new Member States. Sweden's share of intra-EU trade in goods as a percentage of GDP has declined over the last two years in line with the overall trend in EU-15. Although this ratio is roughly the same as in the neighbouring economies of Denmark and Finland, it is considerably lower than the average for small EU Member States.

The structure of trade between the new Member States and the EU-15 has changed significantly since the beginning of the transition. The share of intra-industry trade has been increasing, further underlining the high degree of integration of the new Member States in the European economy. In general, the share of exports of labour-intensive industrial branches and energy-intensive branches has declined while the share of capital-, R&D- and skill-intensive branches has increased[89]. This process has been most pronounced in Hungary and to a lesser degree in the Czech Republic, Poland and Slovakia. The smaller countries seem to have a more specialised production structure, which is reflected in a narrower range of export products e.g. in Cyprus, Latvia, Lithuania and Malta. Nonetheless, there is some evidence that, although the share of intra-industry trade is increasing, the new Member States generally specialise in lower value-added activities while the EU-15 specialise in the higher value-added activities.

89 Landesmann, M. (2003), "Structural features of economic integration in an Enlarged Europe: patterns of catching-up and industrial specialisation", *European Economy* No 181.

Graph 7.7: **Intra-EU trade (2002)**



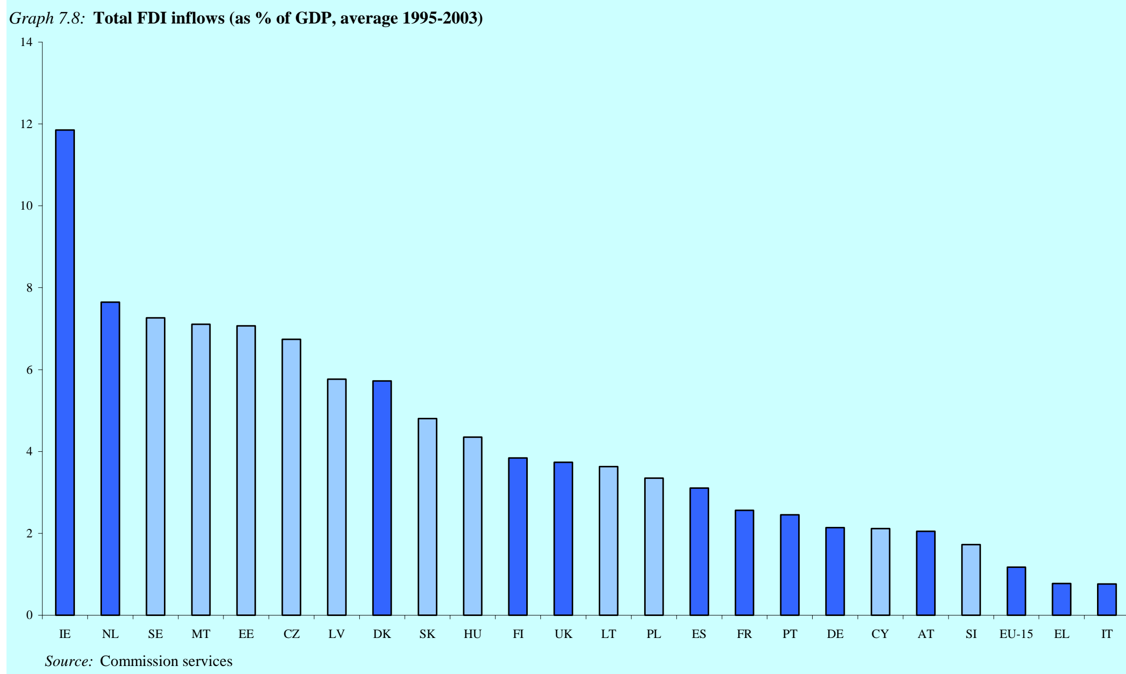
Note: data for Slovenia 2000, Malta 2001
Source: Eurostat

Another indicator that acts as a good proxy for the extent of product market integration is the intensity of foreign direct investment (FDI) flows. FDI has played an important role in the new Member States in the transition. Most importantly, FDI acted as a means of the technology, organisational- and managerial-skill transfer, and contributed to the structural change in the new Member States' economies. Furthermore, it allowed the new Member States to gain easier access to European and other world markets. Finally, FDI flows have helped significantly to cover the high current account deficits which have been an accompanying feature of the transition process. A large part of the FDI flows into the new Member States has been due to the privatisation of state-owned assets. However, the share of greenfield investment has also picked up and in some countries reached considerable levels. This is especially the case of the Czech Republic and Slovakia, due to several large scale investments. In recent years, the share of reinvested earnings in the total FDI volume has been increasing.

Most of the new Member States have experienced large FDI inflows since the mid-1990s. In general, FDI transactions experienced a sustained growth since the mid-1990s, although at a decreasing pace. The EU-15 Member States account for around ¾ of the FDI stocks invested in the new Member States and this share has increased considerably since the mid-1990s. Despite the significant slowdown of FDI extra-EU-15 flows over the recent years, the volume of inward flows into the new Member States from the EU-15 has remained steady.

There is considerable variation among the new Member States in terms of volumes of FDI inflows and their time profile. This points to differences in the catching-up and also the privatisation process. Around 80 percent of FDI inflows since mid-1990s in the new Member States have been directed to the Czech Republic, Hungary and Poland. In terms of the ratio of FDI to GDP, the highest ranking countries have been the Czech Republic, Estonia and Malta. On the other hand, Cyprus and Slovenia have attracted relatively little foreign investment. Sweden has been a favourite destination of FDI flows over recent years, with one of the highest rankings in the EU (see Graph 7.8).

The intensive FDI links and increasing integration in the Internal Market are further confirmed by increasing M&A activity with the EU-25 as measured by both the number and the average value of deals. This rising trend has been interrupted in 2003 as a result of adverse economic conditions.



Graph 7.8: **Total FDI inflows (as % of GDP, average 1995-2003)**

Source: Commission services

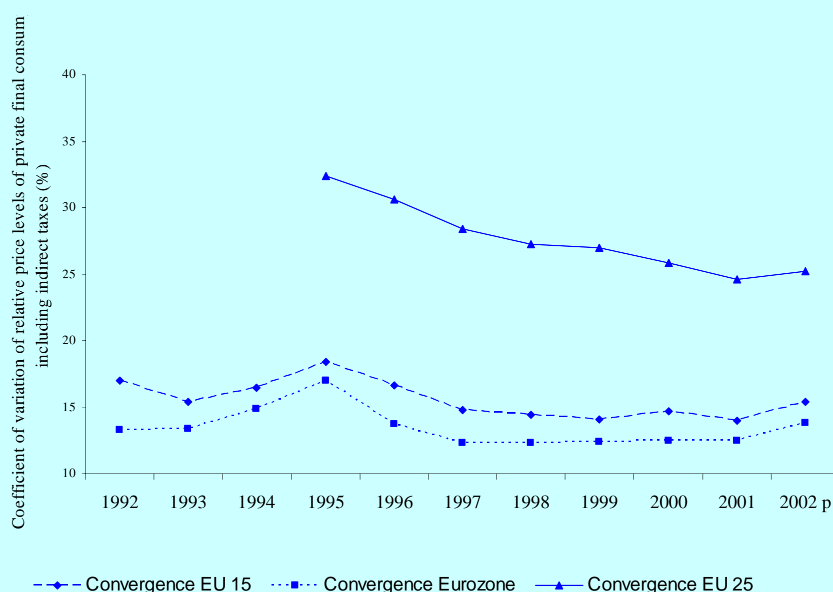
7.1.2.2. Implementation of the Internal Market

In many new Member States the framework for competition in product markets is relatively well-developed, as their economies have been opened up to international competition. While the new Member States have made encouraging headway in strengthening competition rules and establishing independent competition and regulatory authorities, there is still some way to go.

The progress of integration of the new Member States into the EU economy can be documented by the continuing convergence of prices towards the considerably higher levels in the EU-15. Consumer prices in the new Member States have risen significantly in the past years and this may continue due to the catching-up process and the deregulation of administered prices. As a result, price convergence in the new Member States has been faster than in the EU-15 (see Graph 7.9). A moderating effect on the consumer price level is expected from increased competition through imports and the development of more efficiently functioning domestic product markets.

As a result of the significant progress made in opening up the product markets to competition, both from within and from outside the country, Sweden's price level has decreased somewhat but still remains one of the highest in the EU. This high relative price level may be partly attributed to the high levels of indirect taxation in Sweden, but more importantly to a lack of competition in certain sectors, such as the retail and distribution of pharmaceuticals and food retailing.

Graph 7.9: **Price convergence between EU Member States**

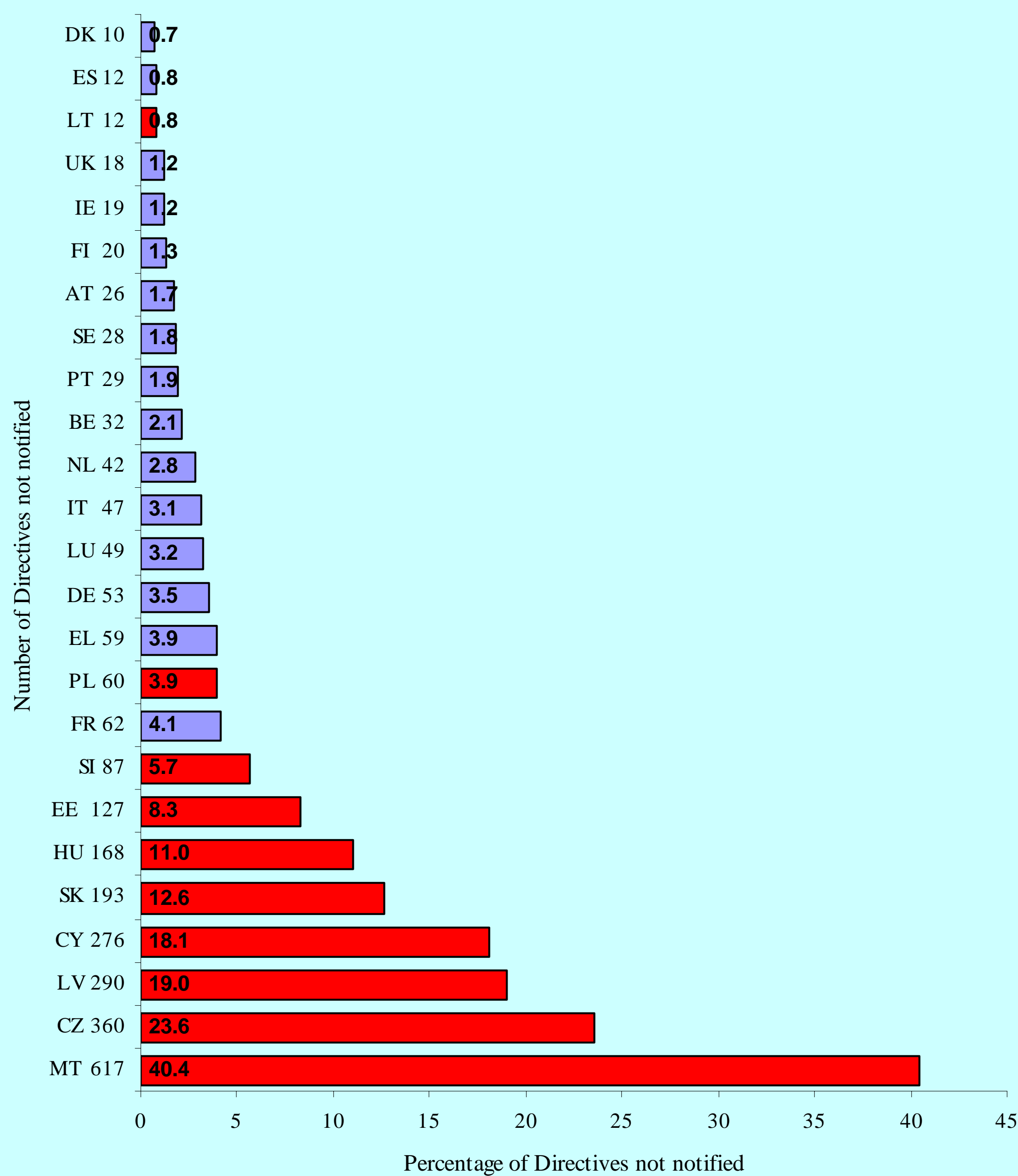


The smooth functioning of the Internal Market in the new Member States might be to some extent hindered by high deficits in transposing and applying the Internal Market directives. The new Member States have on average much higher implementation deficits than the EU-15 Member States. However, in this respect there are also important disparities among the new Member States. On the one hand, Lithuania has a notification deficit of a mere 0.8 percent, placing it among the best performers in the whole EU-25. Poland and to some extent Slovenia are also doing rather well. On the other hand, some new Member States failed to notify the transposition of a significant part of Internal Market legislation, with Malta, the Czech Republic, Latvia and Cyprus being the worst performers[90].

Sweden's implementation deficit of 1.8 percent places the country in the seventh place among the EU-15 and Sweden remains short of the 1.5 percent Lisbon target set for the implementation deficit.

90 These figures might to some extent overstate the transposition deficit where the national implementing measures have been adopted but have not yet been notified due to the short time since the notification obligation came into force (May 2004). In order to gain more precise information, the new Member States have been invited to report what they consider to be the state of implementation. The results of this self-assessment exercise give a roughly similar picture to the notification figures. Lithuania and Slovenia rank in the top places in both exercises, while Malta, Slovakia, Cyprus, Poland and the Czech Republic fare the worst, as each of them has more than 250 directives not transposed. On the other hand, the implementation record might be overstated in some cases since the European Commission has not yet been able to verify whether all the notified measures fully transpose the Internal Market directives.

Graph 7.10: **Transposition deficit (May 2004)**



7.2. Situation and development of the current account of the balance of payments[91]

Eight out of the eleven Member States reviewed in this report are economies that went through a process of transformation from central planning to market economy. This process was associated with a large initial decline of GDP and an important reorientation of trade, in particular exports, from the former eastern block towards the OECD area. As a result, current accounts in the countries concerned recorded only moderate deficits, or even turned positive, at the very beginning of the 1990s.

The overall surge of economic activity towards the middle of the 1990s, including a progressive resumption of investment activity, explains the progressive widening of the current account deficits in the transition economies.

In this period, the new Member States also liberalised transactions on the current and capital accounts. Financing of the current account shifted from loans and transfers from official lenders such as the IMF to private capital, mostly foreign direct investment and, in some cases, debt-creating flows. With the progressively widening current account imbalances leading to increasing doubts about current account sustainability, capital flows started to reverse and provoked in some countries adjustments to their exchange rate regimes (Czech Republic, Hungary, Poland, Slovakia). The impact of the 1998 Russian crisis and of the economic slowdown contributed to an overall decrease of current account deficits in the late 1990s in most of the countries, with the exception of Hungary and Poland.

91 It should be noted that in most of the countries, the methodology used for the collection of statistical data has been progressively adjusted and harmonised with EU standards. Thus, comparable data for some countries are only available for the most recent period.

Table 7.2
Current account of the balance of payments

(national accounts definition, as percentage of GDP)

	1998	1999	2000	2001	2002	2003
CZ	-2.2	-2.7	-4.9	-5.4	-5.6	-6.2
EE	-8.6	-4.4	-5.5	-5.6	-10.2	-13.2
CY	--	--	--	-3.4	-4.7	-3.6
LV	-9.7	-8.9	-6.5	-8.9	-6.9	-8.6
LT	-11.7	-11.0	-5.9	-4.7	-5.2	-6.9
HU	-7.2	-7.8	-8.7	-6.2	-7.1	-8.9
MT	-6.2	-3.4	-13.5	-4.5	-1.1	-5.9
PL	-4.1	-7.6	-6.0	-2.9	-2.7	-2.0
SI	-0.6	-3.3	-2.8	0.2	1.4	0.1
SK	-9.6	-5.7	-3.5	-8.4	-8.0	-0.9
SE	3.9	4.3	4.1	4.4	5.4	6.4

Source : Eurostat and various national sources

More recently, the slowdown of economic growth in the EU together with a stronger growth momentum in most of the new Member States led to a gradual widening of the current account deficits in six out of the eleven Member States reviewed (Czech Republic, Estonia, Latvia, Lithuania, Hungary and Malta). In the same period, Slovenia's current account went into surplus; Poland and Cyprus saw their deficit narrowing and Slovakia experienced a sharp deficit reduction in 2003.

The recent deterioration, where it occurred, generally looks more benign compared to the sustainability problems recorded by some countries in the 1990s. The recent current account widening in the Baltic States has been associated with strong investment activity underlying the catching-up process. The overall coverage of the current account deficit by foreign direct investment has also been high in recent years, even though it substantially decreased in some countries in 2003. While developments in the trade balance, in particular goods, were better due to stronger export performance, a progressive deterioration of the income balance was observed resulting from the increase of negative net international investment positions. The impact of the negative income balance has been particularly high in Estonia and the Czech Republic, important in Hungary and Lithuania and contained in Latvia and Malta.

Table 7.3
Net foreign direct investment

(national accounts definition, as percentage of GDP)

	1998	1999	2000	2001	2002	2003
CZ	6.3	11.4	8.9	9.0	11.2	2.6
EE	10.2	3.9	6.0	5.7	2.2	8.3
CY	--	--	--	7.6	5.9	3.9
LV	4.6	4.6	5.2	1.8	4.1	3.0
LT	8.3	4.4	3.3	3.6	5.1	0.8
HU	6.5	6.4	4.6	6.9	4.0	1.1
MT	7.2	21.4	16.9	7.2	-11.1	7.8
PL	3.6	4.4	5.7	3.1	2.0	1.8
SI	1.1	0.3	0.4	1.2	6.9	-0.5
SK	1.9	3.5	10.1	7.0	16.3	1.8
SE	-1.9	15.3	-7.2	2.5	0.4	-2.4

Source : Eurostat and various national sources

Over the whole period, foreign direct investment (FDI) has played an important role not only for the financing of the current account deficits, but through its typical import-triggering effect, it also contributed to their creation. The importance of foreign investments for the financing of the current account in the new Member States in general alleviates concerns about sustainability, since FDI stocks tend to be more stable than short-term capital. Recently, in a number of countries, the current account deficits have been increased by profits realised by the foreign-owned sector. To the extent that they are reinvested and not repatriated, these earnings (recorded on the income balance) mitigate foreign exchange pressures potentially generated by large current account deficits. Their importance, however, points to a risk of potentially large swings in FDI flows and should not be overlooked.

In considering the recent current account developments in the new Member States, four groups of countries can be identified.

- The first group only includes Slovenia, which has a long tradition of a balanced current account with the exception of the 1999-2000 period, when buoyant domestic demand led to a temporary deterioration of the external balance. Slovenia has recorded a current account in balance or in surplus in the last three years, a feature quite unusual among the new Member States and partly explained by the continuous depreciation of the tolar against the DEM and the euro. Until 2003, Slovenia also recorded relatively modest, albeit positive, net foreign direct investment inflows, with the exception of 2002, when banking privatisation and a large sale to foreign investors in the pharmaceutical sector boosted foreign direct investment to close to 7 percent of GDP. As a result of higher investments by Slovenian firms abroad, foreign direct investment turned negative for the first time in 2003.

- The second group of countries includes Cyprus, Poland and Slovakia, which are economies with generally low current account deficits.
  It is difficult to assess the medium-term developments of the current account of Cyprus due to methodological revisions[92]. The small size of the economy and its openness to the rest of the world explain in part the observed volatility of the current account deficit, which peaked in 1998. Recently, the current account deficit narrowed, mostly as a result of a progressively improving world economic

92 The Cypriot current account deficit has been marked by an important methodological revision introduced in 2002 and so far implemented to the historical time-series since 2001. Its most important feature was the inclusion of the large foreign business sector having physical presence in Cyprus in the residents' category, which significantly boosted exports of services and at the same time led to a highly negative income balance.

environment which boosted exports of services. The Cypriot current account deficit is to an increasing extent financed by foreign direct investment, the reporting of which has, however, also been affected by methodological revisions.

Following a progressive deterioration of the Polish current account in the 1990s, the deficit narrowed from its peak of over 7 percent of GDP in 1999 to 2 percent in 2003. Important factors included sluggish domestic demand and a progressively improving cost and competitiveness position, linked to a sustained effective depreciation of the Polish zloty and to rising productivity.

The Slovak current account also improved substantially from persistently high deficit levels above 5 percent of GDP since 1996 (with the exception of 2000) to a deficit below one percent in 2003. The reduction was associated with a strong growth of exports, made possible by recent large foreign direct investment, and to very subdued domestic demand.

- The third group of countries includes the Czech Republic, Lithuania and Malta,, i.e. countries with relatively large current account deficits, but where sustainability appears to be less of an issue.

  The Czech current account deteriorated rapidly in the mid-1990s from a surplus to a deficit of above 7 percent prior to the 1997 economic downturn. The ensuing strong drop of GDP growth led to a sharp correction of the external imbalance in 1998. Since then, the current account deficit has shown a slow but continuous deterioration peaking at over 6 percent in 2003. However, the structure of the deficit has changed. An improving export performance linked to a higher non-price competitiveness of the Czech economy led to a continuous narrowing of the negative balance of trade in goods which had been behind the substantial deficits in 1996 and 1997. The recent increase of the current account deficit is mainly due to a widening income balance, associated with reinvested profit earnings linked to past inflows of foreign investment.

  The current account of Lithuania deteriorated between 1996 and 1998 due to competitiveness losses caused by wage growth outpacing productivity, fiscal imbalances and an appreciation of the nominal effective exchange rate caused, in part, by depreciations of the currencies of the countries of the Community of Independent States. The deficit subsequently narrowed considerably from 2000 onwards in the context of the economic slowdown following the Russian crisis. The adjustment was also helped by fiscal consolidation and a low growth of unit labour costs. As was the case in some other countries, the deterioration from some 5 percent in 2002 to close to 7 percent in 2003 was mainly associated with a negative income balance due to reinvested earnings. While foreign direct investment has been around 4 percent or higher since 1998, the end of the privatisation process led to a substantial lowering of foreign direct investment in 2003 and an increased share of debt-creating instruments in financing of the current account deficit.

  Malta has traditionally had a fairly volatile current account, reflecting the strong impact of one-off operations on its small economy. The current account deficit ballooned from less than 4 percent in 1999 to over 13 percent in 2000, before receding to a mere 1 percent in 2002. The external balance worsened again to close to 6 percent of GDP in 2003, on the back of a deterioration in both the trade and the service balance. Foreign direct investment inflows are relatively strong, but tend to be volatile year-on-year; in 2003, the external deficit was more than fully financed by foreign direct investment inflows in the order of 8 percent of GDP.

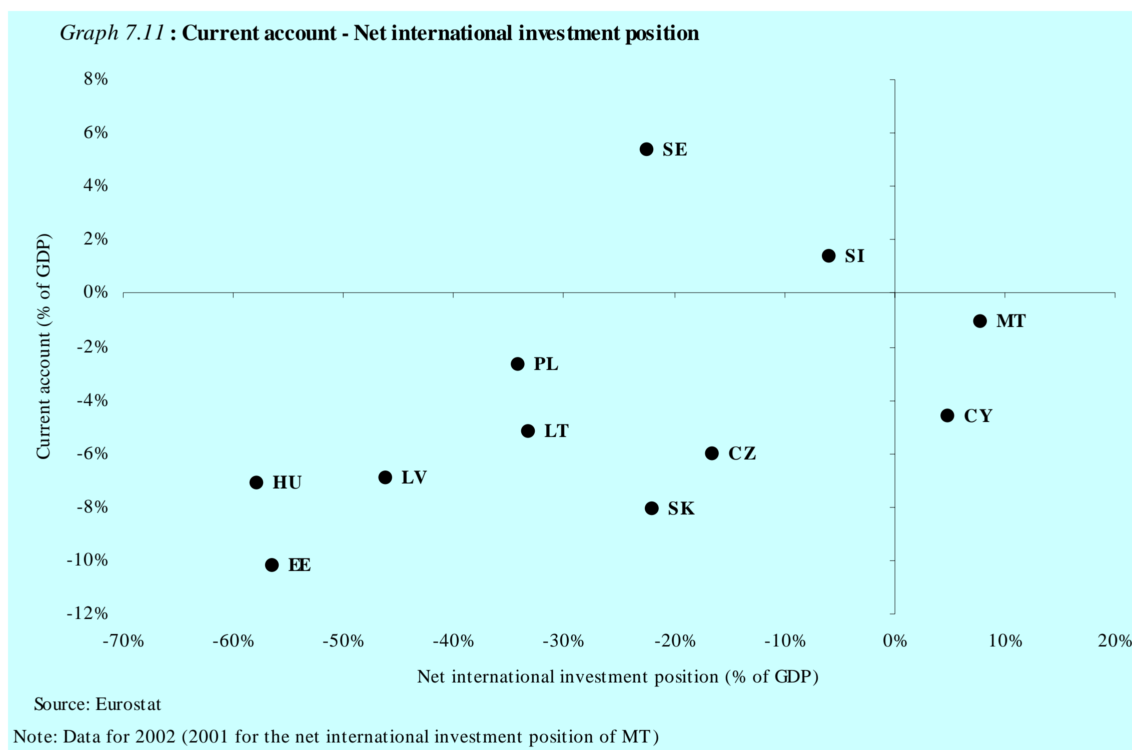
- Lastly, Estonia, Hungary and Latvia have faced large current account deficits. While this does not automatically imply a sustainability problem, external sector developments deserve close monitoring in the three countries.

Estonia's current account has been in deficit since 1992 and the gap reached 13.2 percent of GDP in 2003. The progressive widening of the deficit – which was interrupted only in 1999 as a consequence of the recession in the aftermath of the 1998 Russian crisis - mainly reflects the momentum of the catching-up process of the Estonian economy and in particular a strong investment performance not matched by domestic private savings. More recently, the current account deficit has also been boosted by a strongly negative income balance, reflecting the importance of reinvested profits by the foreign-owned sector. Foreign direct investment coverage of the current account deficit has considerably fluctuated over the past ten years, mostly reflecting the impact of large investment projects and privatisation. As a result, gross external indebtedness has also increased, reaching 75 percent of GDP in 2003.

In Hungary, following a progressive deterioration between 1997 and 2000, the current account deficit improved in 2001 following the economic slowdown. A domestic demand pick-up boosted by significant wage increases resulted in a subsequent widening of the deficit to some 9 percent in 2003. As foreign investment progressively slowed down from a peak in 1996, the net foreign direct investment coverage of the current account deficit also progressively narrowed and became close to inexistent in 2003. As a result, the bulk of the deficit was financed by debt-creating instruments, primarily public debt issues.

The external position of Latvia has also been progressively deteriorating between 1995 and 1998, when it turned from a surplus into a deficit of almost 10 percent of GDP. Since 1999, the external position has persistently been in deficit, reaching over 8 percent in 2003, and is expected to remain high in the near future. The deficit primarily reflects a large trade balance gap triggered by strong growth of domestic investment demand linked to the restructuring process. Until recently, the current account deficit has been to a large extent financed by foreign direct investment inflows, but their importance is progressively diminishing as privatisation and other big investment opportunities become fewer. In 2003, debt-creating financing has been the most important source of coverage of the current account deficit.

In the 1970s and 1980s Sweden emerged as a significant international net debtor because a combination of low private and public saving and recurring competitiveness problems created substantial current account deficits. Sweden's position changed after the deep recession at the beginning of the 1990s. The large depreciation in November 1992 and continued depressed private domestic demand, in combination with consolidation of public finances, generated large current account surpluses. The current account surplus remained substantial at above 4 percent of GDP between 2002 and 2003, signalling continuously strong external competitiveness of the Swedish economy.



Graph 7.11 : **Current account - Net international investment position**

Source: Eurostat

Note: Data for 2002 (2001 for the net international investment position of MT)